

**GAO**

Report to the Chairman, Subcommittee on  
Conservation, Credit, and Rural  
Development, Committee on Agriculture,  
House of Representatives

April 1987

# FARM CREDIT

## Actions Needed on Major Management Issues



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United States  
General Accounting Office  
Washington, D.C. 20548

Comptroller General  
of the United States  
B-220507

April 1, 1987

The Honorable Ed Jones  
Chairman, Subcommittee on Conservation,  
Credit, and Rural Development  
Committee on Agriculture  
House of Representatives

Dear Mr. Chairman:

Your April 24, 1986, letter asked us to provide an overview of the important issues confronting the Farm Credit System, which holds almost one-third of the nation's agricultural debt. The System has been experiencing severe financial difficulties due to adverse economic factors and poor management practices and decisions. Considerable debate exists on how to stabilize the System's rapidly deteriorating fiscal condition and resolve its perplexing problems. Various proposals are under active deliberation.

Understanding the management problems that contributed to the current situation is essential to making informed decisions on how to best deal with the System's dilemma. This report describes management and structural causes of the System's problems and explains how critical System management processes work. The report also highlights the major management challenges that must be addressed in reaching an effective solution.

While understanding the System's management problems is essential, many other economic and policy considerations are involved in reaching a decision on its future. As a result, this report does not offer a recommended course of action. At your request, we are currently analyzing alternative proposals for dealing with the System's problems and will present the results of these analyses in the near future.

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## Causes of the System's Distress

The System continues to experience severe fiscal stress. As discussed in our latest report,<sup>1</sup> the quality of its loan portfolio deteriorated significantly during 1985 and its surplus declined by almost half. The System has announced that it incurred an operating loss of over \$1.9 billion as

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<sup>1</sup>Farm Credit System Analysis of Financial Condition (GAO/GGD-86-150BR, Sept 18, 1986)

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of December 31, 1986, and its independent accountants will issue a qualified opinion on the 1986 combined financial statements. The System and its regulator, the Farm Credit Administration (FCA), generally agree that the System's problems will continue.

Various external economic factors and internal management practices have contributed to the System's financial stress. To a large extent, its problems are a result of a combination of poor management, the deterioration of the agricultural economy, and the increased volatility of interest rates that occurred following the shift in monetary control philosophy by the Federal Reserve in 1979. The System will be severely challenged to overcome poor management of its lending and funding operations, weaknesses in the System's organizational structure, and inefficiencies in its operations while at the same time fulfilling its congressional mandate to provide credit on reasonable terms to the nation's farmers.

The changing fortunes of the agricultural economy have significantly affected the System's financial viability. In the 1970's, as export markets expanded rapidly, the increased worldwide demand for agricultural products pushed up commodity prices, land values, and farm income. Supported by a positive outlook for income and the rapid increase in land values, farmers borrowed heavily to expand their operations.

Two other factors contributed to the expansion of System loan volume. First, a 1971 legislative change in the Farm Credit Act liberalizing collateral requirements allowed System banks to make loans equal to a higher percentage of the value of farm land. Second, System management actively pursued an increasing share of the market by offering variable rate loans priced below the lending rates charged by competitors. The variable rates were periodically increased during the 1970's and early 1980's to reflect rising interest rates but still generally remained below those offered by competitors. As a result, farmers borrowed heavily from System banks.

In the early 1980's international demand for U.S. agricultural products declined significantly, leading to a drop in commodity prices, farm income, and land values. As a result, many farmers lacked either the cash necessary to repay their loans or sufficient collateral to refinance them. On many loans, collateral became marginal or insufficient, leading to a significant deterioration in the quality of the System's loan portfolio.

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In addition, market interest rates—which had been rising since 1977—declined sharply in the early 1980's. By the beginning of 1985, rates charged by competitors had fallen below the System's lending rates, a condition that continues. Some System banks are constrained from lowering their lending rates because of their high debt costs. Consequently, some creditworthy borrowers have left the System, leaving its loan portfolio increasingly comprised of borrowers whose credit is not sufficient to qualify for competitors' lower interest rates.

As its loan portfolio deteriorates, the System must, to follow generally accepted accounting principles, maintain a large allowance for potential bad debts. This caused operating losses and a reduction in accumulated surplus starting in 1985. For example, the System recorded expenses of almost \$3 billion and \$1.8 billion in 1985 and 1986, respectively, to increase its allowance for loan losses, thus ending 1985 with a record loss of about \$2.7 billion and 1986 with a loss of \$1.9 billion.

At the same time economic influences were adversely affecting the System's fiscal posture, System bank management made a series of decisions which also contributed to the problems. These decisions, which were made against the backdrop of optimistic economic expectations that later failed to materialize, set the System on a path toward high-risk funding and lending policies. Moreover, the System's decentralized organizational structure made it difficult to adjust its policies in a rapidly changing environment and to confront emerging Systemwide management problems. Examples of these management decisions follow:

- In the 1970's, System banks, with FCA's concurrence, aggressively sought to increase loan volume by using average costing to price their variable-rate loans at interest rates well below competitors' rates. The System funded its growing loan volume in part by issuing fixed-rate noncallable term debt carrying maturities substantially longer than those of its loans. As interest rates rose, this practice continued and by the early 1980's, the System had a substantial amount of debt carrying high (up to 17 0 percent) interest rates. In the mid-1980's, after market interest rates had dropped, System banks' high average debt costs prevented them from lending at competitive rates to their better quality customers. System officials said that as rates from other lenders declined, borrowers who could refinance elsewhere did so. The System still needs to service the outstanding debt, despite the loss of borrowers on whose behalf it had been issued.
- The decision to issue noncallable term debt, together with the decision to offer variable-rate loans with no prepayment penalty, also resulted in a

mismatch between the maturities of assets and liabilities. Had the System more closely matched the frequency with which its debt and loans are repriced, we estimate that the System's interest expenses during 1985 and 1986 would have been reduced by \$3.4 billion.

- System management did not correct recognized weaknesses in their credit operations. In some districts, credit specialists found an environment that promoted loan volume rather than loan quality.
- Until 1985, the System neither consolidated its financial statements nor acted on advice to hire an independent auditor. This may have prevented a clear picture of the System's fiscal stress from emerging earlier than it did.
- Fearing the loss of local control, System management has resisted several internal and external proposals for increasing management centralization and authority. As a result, although all System banks are jointly and severally liable for consolidated debt of about \$60 billion, the System's current structure inhibits management's ability to develop effective solutions to Systemwide problems and to ensure that individual banks and associations operate under sound business practices.

As discussed in the following sections, overcoming these problems represents a serious challenge to System managers and policymakers. The System's four major management challenges are:

- developing an organizational structure that establishes management accountability and responsibility for Systemwide actions,
- lending at competitive interest rates while generating sufficient income to arrest the financial deterioration of the System,
- creating an effective credit management process, and
- retaining investor and borrower support.

While System management has proposed a number of initiatives to correct these weaknesses, their ability to implement these proposals effectively is subject to serious question under the current organizational arrangement.

## Managing Organizational Change

The System is a complex organizational structure which historically has emphasized decentralized decisionmaking, accountability, and authority. As discussed more fully in section 1, the System is at once a single entity (its banks are jointly and severally liable for consolidated Systemwide debt of about \$60 billion) and hundreds of individual entities. It comprises 37 individual banks (three legally distinct banking systems—Federal Land Banks, Federal Intermediate Credit Banks, and Banks for

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Cooperatives—operating in each of 12 autonomous districts and a Central Bank for Cooperatives), over 400 associations, and numerous coordinating organizations and committees.

Recently, the System's structure has been moving toward increased consolidation. This trend has been accentuated by efforts to cope with its fiscal dilemma. From 1983 through 1985, the System consolidated management at district levels. Between May 1985 and June 1986, it consolidated 45 percent of its local lending operations. These changes represent an attempt to make the System's structure more efficient and responsive to Systemwide needs.

However, no one System organization is accountable for critical management decisions or has the authority to ensure compliance with Systemwide standards. The System has considered but not adopted various reorganization proposals involving greater centralized management and authority. Resistance to these initiatives has centered around concerns over the loss of local control.

The Farm Credit Amendments Act of 1985, Pub. L. No. 99-205, installed the Farm Credit System Capital Corporation in the key but limited management role of channeling financial assistance from relatively strong System institutions to those experiencing difficulty. However, several district banks and profitable local operations challenged in court the requirement that they subsidize unprofitable ones over which they have no control. In some instances, the courts have upheld the challenges. Consequently, the Capital Corporation has been enjoined from collecting assessments from those institutions for the purpose of intrasystem financial assistance.

While the appropriateness of the System's organizational structure may be a longer term issue, the System's senior management has considered a number of initiatives to reorganize the System. These initiatives represent an attempt to strengthen and focus managerial accountability for Systemwide actions. However, as of March 1, 1987, the System's management had failed to agree on any of these proposals.

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## Managing Interest Rates

One critical challenge facing the System is determining appropriate lending rates. Ideally, rates should be competitive enough to retain the System's creditworthy borrowers and attract others, yet be high enough to generate sufficient income to cover its costs, including providing reserves for potential loan losses using generally accepted accounting

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principles. At present, some rates are believed to be noncompetitive and System officials have said that some creditworthy borrowers are leaving.

The Farm Credit Act of 1971 provides that System banks base their lending rates on the cost of debt, necessary reserves and expenses, and member/borrower services. In general, System banks price their loans based on the average cost of their outstanding debt. That is, System loan rates are based mostly on past, not current costs. However, this pricing method runs counter to commercial bank loan pricing practices of basing loan rates largely on the current cost of funds.

During the 1970's and early 1980's, a period of generally rising interest rates, the System's method of pricing its loans allowed its banks to earn a profit while providing borrowers with interest rates lower than those offered by competitors. Most of the System's loans are made on a variable-rate basis. Loan rates were increased during this period to reflect rising interest rates, but generally remained lower than competitors' rates.

The System obtains the funds it loans to farmers by periodically selling securities to the investing public. During the 1970's, the System financed its expanding loan volume in part by issuing long-term fixed-rate non-callable securities. These actions increased the System's exposure to losses in a volatile interest rate environment by increasing the probability that its lending rates would be higher than those offered by competitors if interest rates fell.

As market interest rates began declining in the 1980's, the System found itself locked into relatively expensive sources of funds. To remain competitive with other lending institutions, the System needed to lower its lending rates. It was unable to fully do so, however, because in many instances (especially with the land banks) its average cost of debt exceeded the current cost of debt. Thus, the System was generally unable to pass the lower current borrowing costs to its borrowers and, saddled with high debt costs, it incurred even larger operating losses.

The System faces a loan pricing dilemma. Unless the System lowers its lending rates below its average cost of debt, it may be unable to compete for the financially sound borrowers needed to provide a reliable income base. If it lowers its lending rates below cost, however, the System will

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incur even bigger losses. And it is rapidly depleting the surplus generated from prior profits. At December 31, 1986, its surplus was less than \$1.5 billion, down about \$4.7 billion in 2 years.

The effects of using average rather than current debt costs to set lending rates were heightened by the inadequate matching of the frequency with which the System repriced its assets and liabilities. The System is funded with fixed-rate debt having substantially fewer repricing opportunities than its variable-rate loans. Loans can be repriced monthly, while the average repricing opportunity of System debt (as of August 29, 1986) was 2.1 years. The System thus has exposed itself to a significant interest rate risk because, for competitive reasons, it has not been able to pass all of its historical borrowing costs on to its borrowers.

The System needs to better match the maturities of its assets and liabilities. When it makes variable-rate loans, it must ensure that the borrowings to fund those loans can be repriced at roughly the same frequency as the rates charged on the loans. When it loans long on a fixed-rate basis, it should borrow long with fixed-rate bonds and impose prepayment penalties on the loans. We would support an appropriate asset/liability management program that matched as closely as possible the frequency with which the System reprices its assets and liabilities. In our most recent report (GAO/GGD-86-150BR), we recommended that FCA direct the System banks to collectively develop and implement a plan to reduce interest rate exposure.

System management is aware of the need for, and has drafted guidelines on, managing interest rate risk. The draft guidelines, however, still leave complete control over liability choices with the banks. In addition, the guidelines take no account of the possibility that interest rate risk could be managed and coordinated on a Systemwide basis, given the varying risk exposures among different System institutions. While the System has traditionally maintained autonomous bank structures, greater centralized oversight and accountability may be necessary to ensure that interest rate risk is successfully managed.

To cover the System's operating costs—about 10 percent of total expenditures—banks add over 1-1/2 percent to their lending rates. In 1985, operating costs for the entire System totaled \$882 million, an increase of \$262 million, or 42 percent, over the System's 1981 total. Over the same period, the cost of living (as measured by the Consumer

Price Index) rose 18 percent. System salaries and benefits, which constitute about 60 percent of total operating costs, grew from \$387 million in 1981 to \$534 million in 1985. This growth was due in part to the addition of employees, including staff needed to service troubled debt. Another major cost item was occupancy expense, which increased from \$52 to \$87 million (67 percent) over the same period, due in part to new construction. For example, from 1980 to 1985 five districts, FCA, and the Central Bank for Cooperatives constructed new facilities. Finally, the System spent \$55 million in 1985 on communications and data processing, up from \$38 million in 1981.

System and FCA management have said that certain operating costs are excessive and should be substantially reduced, primarily by eliminating excessive and duplicative costs resulting from the System's decentralized organizational structure. In particular, officials believe costs can be reduced by increased data processing standardization, greater centralization of some administrative functions, and reductions in staff. If fully implemented, the System's reorganization proposals are projected to save about \$360 million per year.

For the years 1987 to 1989, each System district is to adopt an "operating cost target," which is designed to "achieve a competitive system total operating cost relative to total system volume." However, each district will determine what is a competitive operating cost for its operations. District-directed operating cost strategies generally have not resulted in an efficient Systemwide operating cost structure. We believe that substantive cost control initiatives will require a detailed Systemwide action plan. Section 3 provides further information on the System's funding and lending operations and its operating costs.

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## Managing Credit Operations

As the agricultural economy worsened, the quality of the System's loan portfolio also significantly eroded. This decline, coupled with the identification of numerous management weaknesses by its independent auditor, prompted an extensive re-examination of credit operations. As a result, the System has established national credit standards and included several credit management initiatives in its Strategic and Business Plan.

The System's independent auditor emphasized that individual banks and associations must promptly implement the new standards for improving

accounting principles. In addition, System management adopted national standards for automating accounting and financial systems.

Much more effort is required, however, to ensure that such initiatives are effectively implemented. In particular, as noted by its auditor, the System must give high priority to implementing its proposed automated financial system, including standardized data bases and general ledger accounting software, to consolidate quarterly and annual financial information quickly and accurately. Further information on investor and member/borrower relations is in section 5.

## Farm Credit Act Amendments of 1986

The Farm Credit Act Amendments were enacted on October 21, 1986. Essentially, this legislation allows the System rather than FCA to set lending rates and authorizes the System, in accordance with FCA regulations, to capitalize certain expenses and amortize them over 20 years. In particular, the System can capitalize interest expense judged excessive under definitions in the amendments and provisions for losses in excess of one-half of 1 percent of loans outstanding. The amendments also exempt System banks, with the prior approval of and subject to conditions imposed by FCA, from accounting for these actions in accordance with generally accepted accounting principles.

On October 6, 1986, we wrote the Chairman, House Committee on Agriculture, that we have serious reservations about allowing the System to disregard generally accepted accounting principles. Reliance on legislatively sanctioned regulatory accounting in the thrift industry had taught us that any short-term benefits may be outweighed by the long-term costs of not dealing with financial problems in a direct or forceful manner. We estimated that the accounting changes allowed by the legislation could overstate earnings by \$5 billion or more over the next 30 months.

More importantly, we wrote that this legislation could impede the speed of reforms to the management practices and operations of the Farm Credit System that were contemplated by Congress when the 1985 amendments to the Farm Credit Act were enacted. In addition to putting the System on a solid basis of financial accounting, the 1985 Amendments were designed to achieve desperately needed reforms to credit evaluation and approval procedures.

These 1986 Amendments were expected to have short-term salutary effects on the appearance of the System's financial condition. However

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given the continued rapid deterioration of that condition in certain districts, it now appears they will not substantially delay the need for federal assistance.

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## Conclusions

The Farm Credit System was created by Congress with the mandate to provide credit on reasonable terms to the nation's farmers. It has historically provided loans at rates equal to or less than those offered by other private sector lenders. And it provided available credit during depressed times as well as boom years. In so doing, it became the nation's largest agricultural lender.

The System now faces severe financial difficulty, as reflected primarily by the poor quality of its loan portfolio and its high cost of debt. In part, this condition resulted from factors beyond the control and influence of the System, such as decreasing agricultural income, falling land values, and a steep decline in market interest rates. In part, it resulted from poor management practices and decisions, such as lax credit standards and mismanagement of interest rate risk.

The System is further burdened by a complex and decentralized organizational structure devoid of centralized decisionmaking, accountability, and authority. It consists of hundreds of separate and distinct legal entities. System banks and associations have historically retained the strong individual identities of their indigenous farm communities. Their locally elected Boards of Directors are responsible for furthering the goals of their individual borrowers and are not required to coordinate with or consider the effect of their actions on other Farm Credit institutions.

Many options exist to resolve the dilemmas described above and address the causes of the System's problems. These options include fundamental changes to the System's organizational structure. Several of these proposals are currently being evaluated by the System, FCA, and the Department of the Treasury

In the draft of this report submitted for comment to the System and FCA, we had recommended that, as long as the System's debt continued to be the joint and several liability of all of the System components, a centralized source of accountability be established within the System to promulgate binding uniform standards of business conduct on System units.

The System generally agreed with our proposed recommendation and FCA disagreed with it. The System response (see app. IV) said that the

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Farm Credit Corporation of America (FCCA), the Presidents Planning Committee, and most System banks support our proposed recommendations, but that not all System entities support the concept of a strong central organization.

FCA opposes System centralization (see app. V). It believes that the System's efforts should be directed at addressing its problems rather than creating a new vehicle to solve them. It states that the System can function as an efficient delivery system for financial services if it properly channels its energies to address and eliminate its inefficiencies. It further points out that the System's cooperative nature should cause it to act in concert because of its joint and several liability obligations.

We find FCA's response inconsistent. While opposing centralization, FCA wants the System to address its problems, efficiently deliver financial services, and correct its inefficiencies, as if it were a single cohesive organization. We also disagree with FCA's assertion that the System's cooperative nature can be sufficient to cause its many institutions to act cohesively. For example, the Farm Credit Banks of Texas recently withdrew their support of FCCA, the System's central policy-making institution, because of philosophical differences. In addition, several institutions have filed lawsuits challenging and thus blocking the transfer of surplus from financially healthy entities to ailing ones. The actions clearly show that, as presently organized, the System cannot require its entities to act in concert.

Nonetheless, one overriding System attribute makes it, in fact, a single entity: Its \$60 billion of consolidated Systemwide debt is the joint and several liability of all 37 System banks. Thus, when the bank primarily liable is unable to make payment, the remaining banks must provide funds to redeem the securities at maturity.

FCA offers a solution to the System's problems, "a combination of appropriate regulatory and supervisory actions coupled with needed market discipline," wherein System institutions would compete not only with other lenders but also with each other. FCA acknowledges that this may lead to the failure, merger, or liquidation of the weak institutions, and believes this would strengthen rather than damage the System. Given the current condition of the System and the agricultural economy, we question whether more competition between lenders is likely to be of benefit to them as a group without a carefully conceived and administered long-term plan.

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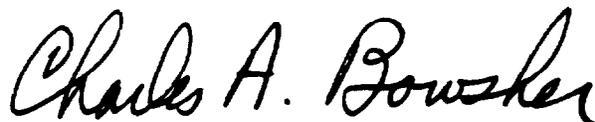
Since we made our draft report recommendations, the System's financial situation has continued to deteriorate. The 1986 Amendments may not provide the System with sufficient time to formulate options for restoring its viability. While we continue to believe that a focal point for Systemwide accountability and authority needs to be established, particularly if the federal government deems it necessary to provide assistance, many other critical economic and policy considerations need to be deliberated in reaching a decision on the System's future. Because any structural changes need to be considered in the context of broader proposals to address the System's problems, we are not making any recommendations at this time. We are, however, evaluating possible responses to the System's dilemma and will report shortly on our findings.

FCA and the System also offered a number of technical comments to the report. These comments, along with our responses to them, are shown in appendixes IV and V.

The objective of this review was to provide an overview of the important issues the System must address. As discussed more fully in section 6, we analyzed the System's structure, operating costs, and processes for policy development, funding, and lending, and examined the reports and management letters produced by the System's independent auditor. Audit work was conducted at FCA and several System locations, including the Funding Corporation and FCCA. Our review was conducted in accordance with generally accepted government auditing standards.

As arranged with your office, copies of this report are being sent to all Members of Congress; the Board Chairman and Chief Executive Officer, FCA; the President and Chief Executive Officer, FCCA; and to others who have an interest in this subject. In addition, FCCA plans to distribute copies to all System entities.

Sincerely yours,



Charles A. Bowsher  
Comptroller General  
of the United States

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**Abbreviations**

BC	Bank for Cooperatives
CBC	Central Bank for Cooperatives
CCC	Commodity Credit Corporation
CEO	Chief Executive Officer
FCA	Farm Credit Administration
FCCA	Farm Credit Corporation of America
FCC	Farm Credit Council
FFCB	Federal Farm Credit Board
FHLB	Federal Home Loan Bank
FICB	Federal Intermediate Credit Bank
FLB	Federal Land Bank
FLBA	Federal Land Bank Association
GAO	General Accounting Office
GSE	Government-Sponsored Enterprise
PCA	Production Credit Association
PPCEC	Presidents Planning Committee Executive Committee
USDA	United States Department of Agriculture



# The Changing Organizational Environment of the Farm Credit System

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“The organizational structure is not an issue which lends itself readily to rational and unemotional discussion within the Farm Credit System. There is general agreement that if the System were to be created anew today, it would not likely be created in the same organizational mold as that which now exists.”

FCA Staff Committee on Farm  
Credit System Coordination  
and Structure, February 1982

Effectively operating the Farm Credit System (System) during the current period of significant financial stress presents one of the biggest management challenges in its history. The System faces this challenge with a complex organizational structure embracing three legally distinct banking systems, hundreds of national, regional, and local boards of directors and numerous coordinating organizations, committees, and subcommittees. Will this structure facilitate or frustrate management initiatives to deal with its financial stress in a forceful manner? Does it require additional change? If so, what should be done? Such questions confront System policymakers as they consider changing the System's organizational structure to increase its effectiveness and cope with its fiscal dilemma.

Successfully addressing these issues requires an understanding of the System's organizational history. Created over 50 years ago, the System has a rich history and reflects three unique organizational attributes.

- Cooperative principles—particularly the principle of democratic control—have strongly influenced the System's organization.
- The complex organizational structure, consisting of three legally distinct banking systems operating within one System, requires extensive coordination—committees, subcommittees, service organizations, etc.—to take Systemwide action.
- The role of the Farm Credit Administration (FCA) has evolved from one emphasizing System promotion and development to managerial involvement to independent regulation.

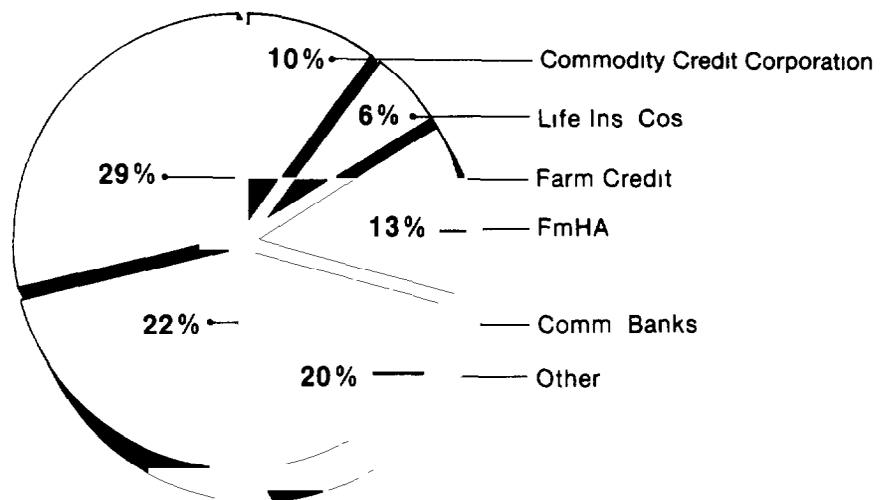
This section describes these trends and highlights current efforts to address the issue of organizational change.

## The Farm Credit System - A Brief Overview

The Farm Credit System was created by Congress to meet the unique credit needs of agriculture. As of December 31, 1985, the System held about 29 percent of the total \$210 billion farm debt. Figure 1.1 displays the distribution of total farm debt among agricultural lenders.

The System is composed primarily of three different bank groups—Federal Land Banks (FLB), Federal Intermediate Credit Banks (FICB), and Banks for Cooperatives (BC)—along with local associations. The three different banks were established separately between 1916 to 1933. Each was intended to serve different purposes.

**Figure 1.1: Market Shares of Major Lenders: Total Farm Debt on December 31, 1985, \$210 Billion**



The FLBs, established in 1916, make long-term (5 to 40 years) real estate and equipment loans to producers through local federal land bank associations (FLBA). The FICBs, established in 1923, make funds available to local Production Credit Associations (PCA) to meet shorter term (10 years or less) operational financing needs. FICBs also provide loan funds and loan discounting services to other financial institutions—including commercial banks, trust companies, agricultural credit corporations, and incorporated livestock loan companies—involved with farm lending. The BCs, created in 1933, finance the marketing and supply operations of agricultural and rural cooperatives, including eligible rural utility and telephone cooperatives and companies.

The System is organized into 12 Farm Credit Districts, each containing an FLB, an FICB, and a BC, along with their local FLBAs and PCAs. The

number of PCAs and FLBAS varies widely by District, ranging from 3 to 72. In addition to the district banks, there is a Central Bank for Cooperatives (CBC) located in Denver, Colorado. The CBC participates in loans that exceed the lending limits of individual district BCs.

## Cooperative Principles Have Influenced the System's Organizational History

In setting up the System, Congress emphasized borrower involvement in organizing and operating the system. To facilitate this involvement, Congress used several organizational principles generally used to run agricultural cooperatives. These include: democratic control (one vote per member); ownership by member patrons; members obligated to finance the cooperative according to their use; limited return on capital; and service at cost. Table 1.1 provides examples of how these principles were integrated into the System.

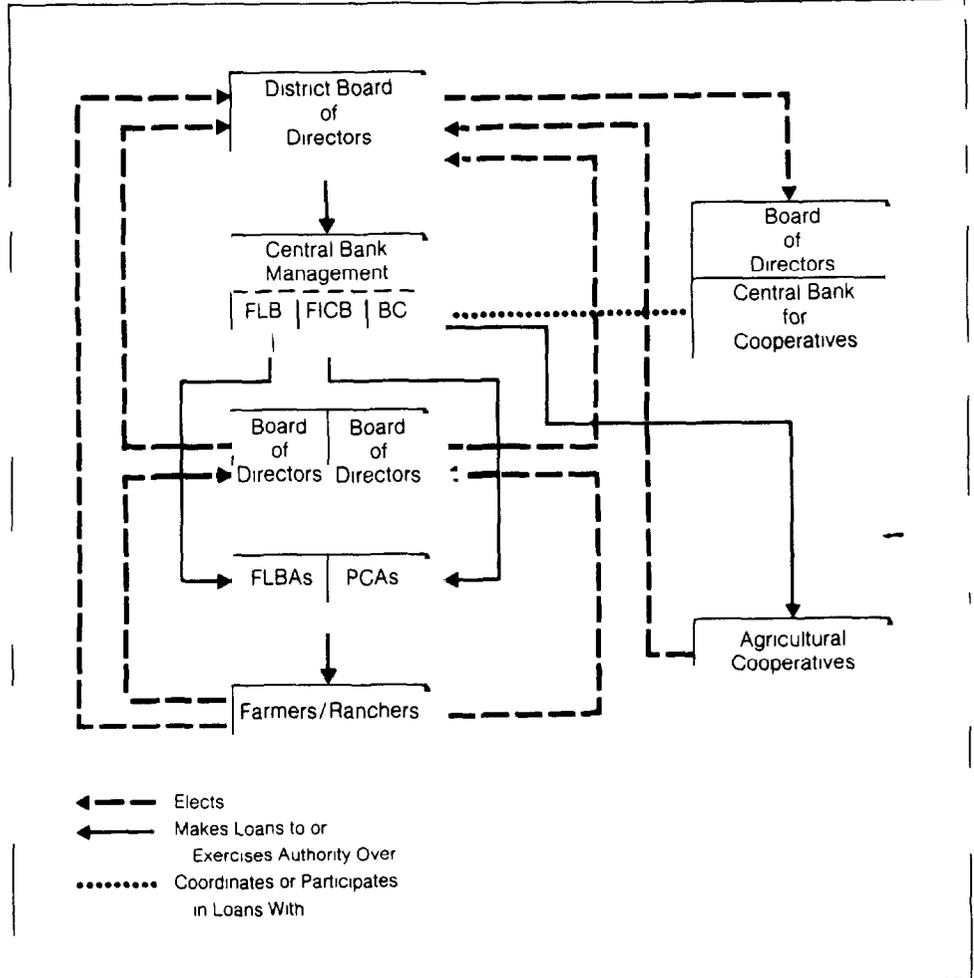
**Table 1.1: Cooperative Principles in the Farm Credit System**

Principle	Examples of System Attributes
1) Democratic control	1a) One vote per member for electing local association directors who establish operating policies  b) Member/borrowers comprise the board of directors for all System banks
2) Ownership by member patrons	2a) All borrowers are required to buy stock  b) Repayment by borrowers of initial government capitalization
3) Members finance according to use	3) Members purchase stock based on a percent (5-10%) of their loan
4) Limited return on capital	4a) Retirement of stock normally at par value  b) Dividends paid on occasion
5) Service at cost	5) Government-sponsored enterprise status (see p. 64), reducing need for System profits to maintain access to investment community funds

From an organizational perspective, the democratic control principle—embodied by the extensive network of member/borrower boards—has been the most prominent cooperative principle. Figure 1.2 shows the basic organization of a district bank and the extensive use of member/borrower boards.

**Section 1**  
**The Changing Organizational Environment of**  
**the Farm Credit System**

**Figure 1.2: The Farm Credit System**  
**Basic District Bank Organization**



A seven-member board of directors establishes policy in each district. The board includes two members elected each from the FLBAs, PCAs, and BC and one elected by the members/borrowers. Within each district, the board oversees the FLB, FICB, and BC, all of which now share common management. Each district board also elects a member of the Central Bank for Cooperatives' Board of Directors. The land bank extends its loans to borrowers through the FLBAs, and PCAs serve as local outlets for the FICBs. The associations are also managed by a board of directors elected from their member/borrowers. In addition, like the district bank, the associations may also share common management.

Another indication of the extensive member/borrower involvement can be seen by comparing the number of member/borrower directors to the

number of System employees. The System's National Directory published in early 1985 listed over 1,200 member/borrower FLBA directors in seven districts. (It listed no directors in the other five districts.) It also listed over 2,000 member/borrower PCA directors. This total of over 3,200 directors equated to one director for about every five System employees. The Texas banks had a director for every two employees. The member/borrower directors and the organizations with which they are associated and System senior management held \$1.3 billion in System loans.

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## Multiple Types of Banks/Associations Require Extensive Coordination

With three types of banks supported by two types of associations scattered within 12 districts, the System has had to develop a number of coordinating mechanisms to deal with situations requiring Systemwide action. This was necessary because the FLBs, FICBs, and BCs have historically retained strong individual identities. For example, until 1953, each type of bank had its own presidentially appointed commissioner. Subsequently, from 1953 to 1972, each type of bank had its own deputy governor within FCA responsible for supervising its type of credit. This separation continued within System districts, as all but Springfield, Massachusetts, and Baltimore, Maryland, had a separate president for each of the three banks until the early 1980's. Reinforcing this separation, FLBA and PCA service areas were often drawn differently within the same district.

In the 1980's, the System has moved toward reducing these individual identities by merging some FLBA/PCA operations, consolidating district bank management and establishing a variety of coordination mechanisms to help facilitate Systemwide action when needed.

Five entities help coordinate Systemwide operations: the Farm Credit Corporation of America (FCCA), the Federal Farm Credit Banks Funding Corporation (the Funding Corporation), the Farm Credit Council (FCC), the Farm Credit Leasing Services Corporation (Leasing Corporation), and the Farm Credit System Capital Corporation (Capital Corporation). The four Presidents Standing Committees also provide coordination on Systemwide issues.

The FCCA, located in Denver, Colorado, was established in 1985. A Board of Directors comprised of individuals elected by the boards of the CBC and System districts oversees FCCA. The FCCA is responsible for developing Systemwide plans and standardized policies on data processing, credit administration, finances, and financial reporting. However, FCCA lacks any direct authority over other System institutions. It depends on

the power of persuasion and the concurrence of the boards of directors of System institutions to effect change. On most matters, FCCA also acts as the System's chief public spokesman. In relations with the federal government, the FCC in Washington, D.C., acts as the System's lobbying organization.

In developing policy directives and standards, FCCA seeks the approval of the appropriate Presidents Committee and the full Presidents Planning Committee. There are four System committees—Planning, Services, Credit and Operations, and Finance. The Planning Committee is comprised of the Chief Executive Officer (CEO) of each district, the CBC, and the FCCA. The CEOs of other System organizations serve as nonvoting members. In addition, there is a Presidents Planning Committee Executive Committee (PPCEC) which acts as a steering committee. The other committees consist of System bank presidents, who serve 3-year terms on a rotating basis. The chairmanship of each committee is rotated among its members annually. Each committee may have a variety of subcommittees.

The System Finance Subcommittee oversees the activities of the Funding Corporation and is involved in determining the amounts, maturities, and rates of interest for System debt issuances, subject to FCA approval. Located in New York City, the Funding Corporation handles the sale of Farm Credit System securities to the Nation's capital markets. A Board of Directors comprised of both bank directors and presidents heads the Funding Corporation.

Finally, the Farm Credit Leasing Services Corporation, located in Minneapolis, Minnesota, provides leasing and related services to System banks and eligible borrowers. Eighteen of the System's 37 banks jointly own the Leasing Services Corporation. Five banks are represented on its Board of Directors.

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## The Evolution of the Farm Credit Administration

The FCA was initially established as a federal agency in 1933. It spent most of its early years restructuring and promoting the Farm Credit System. Six years later, in 1939, the FCA was transferred to the U.S. Department of Agriculture (USDA) and headed by a presidentially appointed governor. During most of the 14 years (1939 to 1953) the FCA was part of the USDA, a national farm organization credit policy committee considered the problems of the Farm Credit System. A large share of this committee's efforts went into discussing various proposals

for insulating the FCA from any possible political influence, a concern that eventually was part of the impetus for the Farm Credit Act of 19

The 1953 Act returned the Farm Credit Administration to an independent agency, established the Federal Farm Credit Board (FFCB) as its governing and policymaking body, and abolished the presidentially appointed governor. The power to appoint all subordinates was given the Governor of the FCA (who was appointed by the FFCB). In 1971, Congress passed a Farm Credit Act that provided an updated charter for the Farm Credit System. As noted in the study that was used as a basis for the 1971 Act, the FCA's role was to "develop and promote the strongest possible Farm Credit organization." In accordance with requirements emanating from the act, other regulations, and its general responsibility to enforce standards for safety and soundness, the FCA continued to make many critical management decisions, including approval authority for bank president salaries, loan lending rates, and all funding decisions.

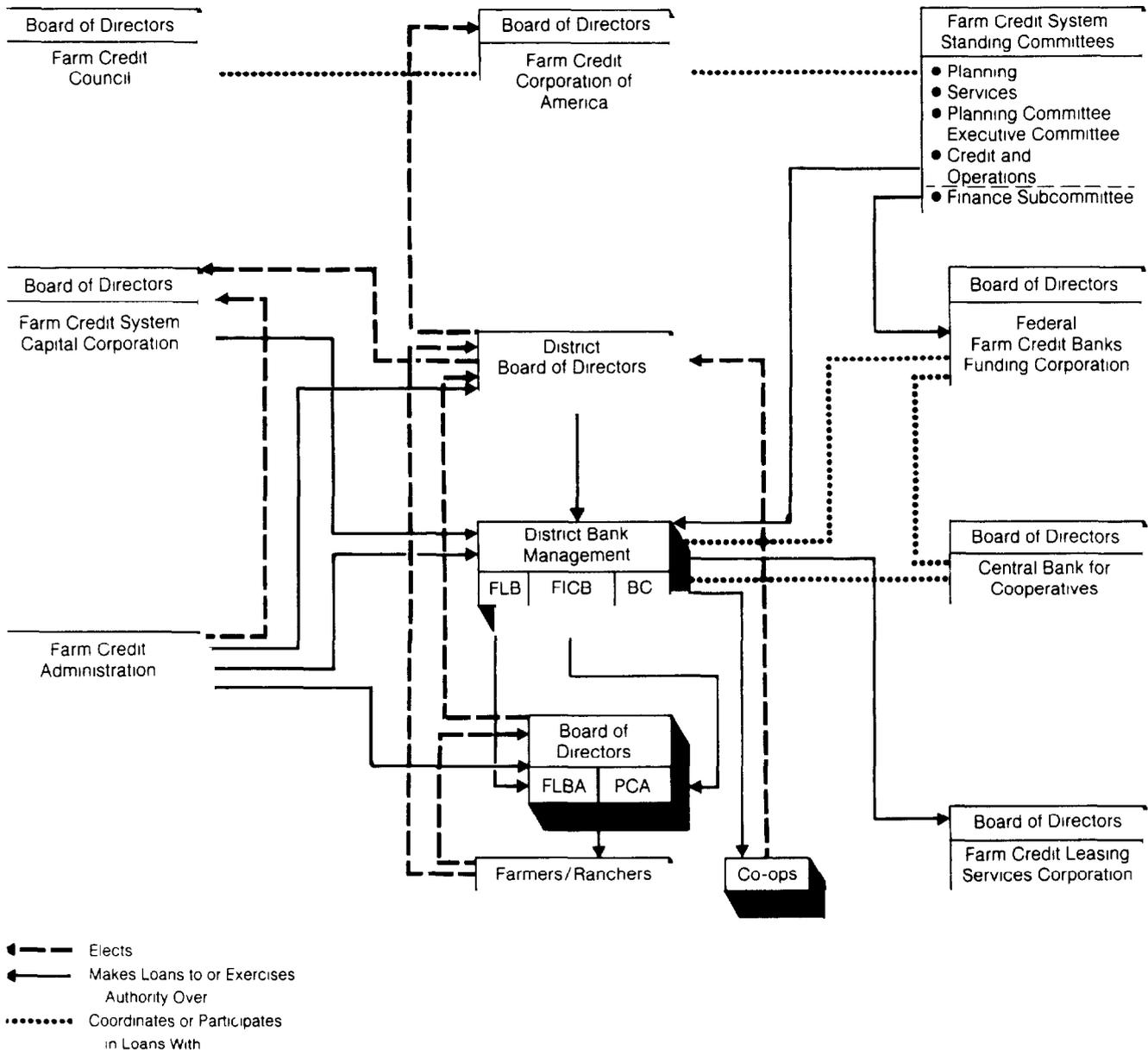
The legislative emphasis was again altered with the passage of the Farm Credit Amendments Act of 1985, which established FCA as an arms-length regulator and strengthened its regulatory authority. In particular, it replaced the FFCB with a presidentially appointed FCA Board, which will manage and administer the agency. One member will serve as chairman and replace FCA's governor. The amendments gave FCA new powers and responsibilities, including the authority to take specific enforcement actions against System institutions and individuals, such as issuing cease-and-desist orders; the authority to issue capital adequacy regulations for System banks; and the responsibility to examine all System institutions at least once each year.

The amendments also created a new Farm Credit System Capital Corporation (Capital Corporation), chartered by FCA, to facilitate the administration of financial assistance to the System. In addition, the amendments provided that with FCA's certification of the System's need for financial assistance, among other things, the Secretary of the Treasury may purchase obligations of the Capital Corporation for the purpose of providing financial assistance to the System.

A composite chart of the entire Farm Credit System is shown as figure 1.3. It shows the FCA added onto the Systemwide coordinating structure and the basic district bank organization.

**Section 1**  
**The Changing Organizational Environment of**  
**the Farm Credit System**

**Figure 1.3: The Farm Credit System**



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## Current System Organizational Change Initiatives

Over the past 6 years, three separate studies have advocated that the System consider consolidating its organizational structure. Each of the studies met with resistance from parts of the System. Currently, the System's Strategic and Business Plan contains an initiative aimed at again reconsidering the consolidation of the System's organizational structure.

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## Prior Studies of System Organization

Since 1980, the System's organization has been reviewed by the General Accounting Office (GAO), a special System management committee, and an outside consultant employed by FCCA. In a 1980 report,<sup>1</sup> we recommended that Congress direct the FCCB to review how best to consolidate or merge the three banking systems into one and prepare legislation to accomplish this. Based on the results of a subsequent 1982 staff study the FCCB decided not to propose a legislative change. Instead, it approved a policy declaring that any decision on System structure should be made by member/borrowers through their elected boards of directors.

Within 2 years, in response to concerns that its structure might prevent the System from responding effectively to emerging challenges, System officials conducted a new study to examine alternative structures. They concluded that the System must

- recognize its total interdependence,
- understand that "borrower-owner control" will be meaningless if decentralization is indulged to the point that it destroys the System's capacity to compete,
- begin promptly to make fundamental structural changes in its corporate organization, and
- proceed rapidly to develop a strong central entity.

This study eventually led to the creation of FCCA in 1985. In reacting to the concerns of some member/borrowers and bank officials regarding the potential loss of control in their bank districts, however, the System provided FCCA with only limited authority over other System institutions. FCCA then engaged an outside consulting firm to evaluate alternative System structures. That study recommended that the System restructure itself to form a modified financial holding company, while maintaining member/borrower control via the local delivery of credit.

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<sup>1</sup>The Farm Credit System: Some Opportunities For Improvement (CED-80-12, Jan 25, 1980)

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Current Organizational  
Initiatives

The System's May 1986 Strategic and Business Plan contained an initiative to reconsider the current organizational structure. This initiative required that a plan be developed which would combine System units to manage the shared risks, improve profitability and competitiveness, increase economies of scale, pool capital, and serve the unique needs of each market segment while retaining local operational authorities to the extent practical. System directors have considered several structural alternatives but as of December 1986 had adopted none.

Given the major challenges facing the System, this reconsideration of the System's organizational structure comes at a pivotal point in its history. As discussed in the following sections, System managers face critical challenges in such areas as setting lending rates, managing interest rate risk, controlling operating costs, improving credit operations, and managing investor and member/borrower relations. Historically, the responsibility for taking corrective action in areas such as these has generally rested with district management. However, district-directed strategies have not produced effective Systemwide results.

We believe it imperative that the System locate responsibility and accountability for Systemwide initiatives in a focal point, as this directly affects the System's ability to successfully implement short-term actions to correct its weaknesses and long-term management reforms needed to ensure viability.

# The Farm Credit System Under Stress

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“Looking backward from 1985, the most likely pattern for 1980 would be seen as lean year in a series of years which on average were generally favorable. Thus, leaner 1980 prospect does not portend a long-term trend in that direction.”  
FCA Agricultural and Credit  
Outlook '80

“At first many farmers as well as agribusinesses assumed that the downturn was temporary and that things would soon get better.”  
FCA Agricultural and Credit  
Outlook '85

The agricultural boom in the 1970's was followed by a dramatic downturn in the early 1980's. Major portions of the agricultural sector—particularly the Midwest—have experienced a period of prolonged decline in farm land values and commodity prices, producing inadequate earnings to pay for farmer debt. At the same time, the Farm Credit System has also experienced financial stress, particularly in its Midwestern districts. This stress has included deteriorating loan portfolio quality, shrinking surplus levels, declining levels of loans outstanding, and rising levels of acquired property. In a recent report, Farm Credit System: Analysis of Financial Condition (GAO/GGD-86-150BR, Sept. 18, 1986), we projected that the System could essentially deplete its remaining surplus by the end of 1986.

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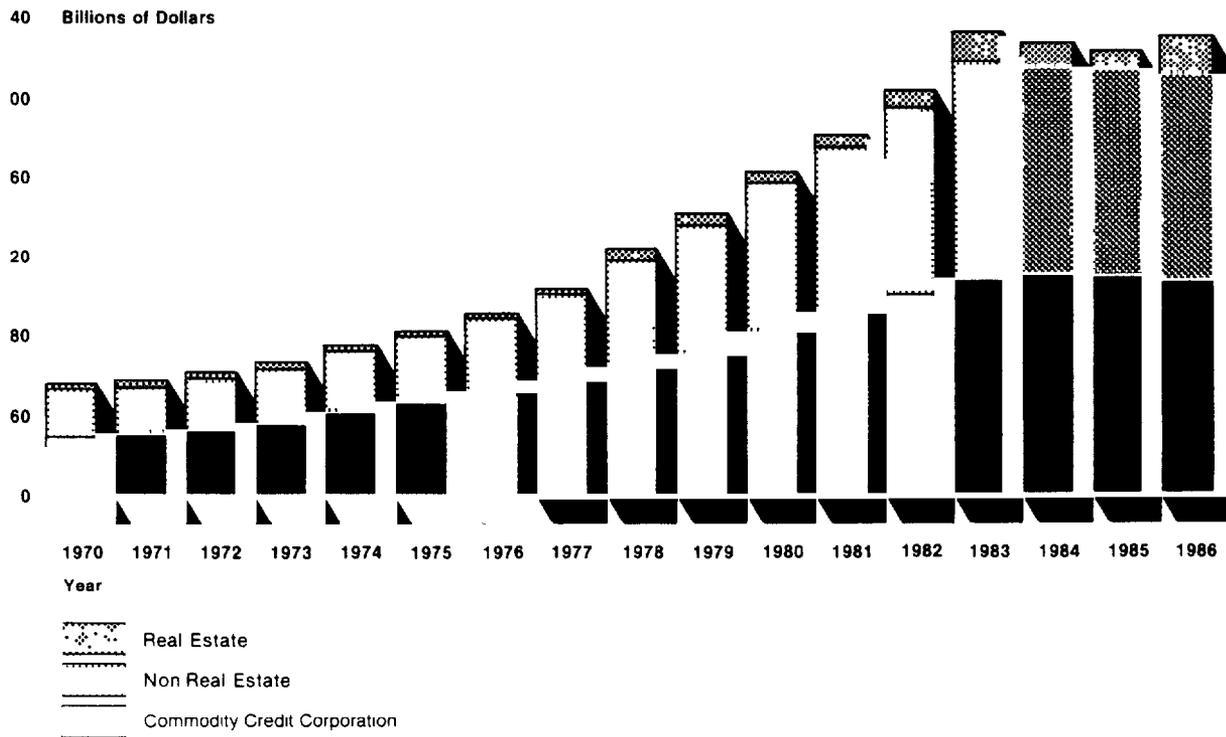
## Changing Fortunes of the Agricultural Sector

During the inflationary decade of the 1970's, export markets expanded rapidly, crop yields and commodity prices were high, and real interest rates (i.e., the difference between the rate of inflation and the interest rate charged by lenders) remained low. From 1972 to 1980, agricultural exports rose from just under \$10 billion to over \$40 billion. In 1980 alone, exports rose 27 percent. At the same time, commodity prices generally increased. In response, farmers brought idle land into production, dramatically increasing earnings.

High inflation rates also led farmers to expand their operations. Spending on fixed assets such as land provided a hedge against inflation, and capital for expansion was available at low real interest rates. With the demand for land increasing and land earnings increasing, land values increased sharply. From 1973 to 1981, land values increased 11 percent nationally. The size of the increases, however, was not uniform across all the states. Increases generally were largest in the Midwest where grain and feed production and prices responded to the rising demand for exports.

Supported by a positive outlook for income and a rapid increase in land values, farmers borrowed heavily to invest in new capital equipment and to purchase the increasingly expensive farmland. Farm debt escalated rapidly. Financed with low real interest rates, total farm debt increased from \$53 billion in 1970 to about \$230 billion in 1986. Interest expense on this debt was the fastest growing farm expense in the 1970's, showing a five-fold increase. Figure 2.1 indicates the rapid growth in farm debt.

Figure 2.1: Farm Debt Outstanding January 1, 1970 to 1986



As late as 1980 and 1981, favorable conditions in the agricultural sector were expected to continue well into the decade. Subsequent events, however, proved these predictions wrong.

In the 1980's, demand declined as a result of international factors such as competition from foreign suppliers and a stronger dollar. From 1981 to 1986, U.S. agricultural exports fell 20 percent and commodity prices declined.

The decline in commodity prices led to decreased farm income and profit per acre. As a result, land prices began to drop sharply. Nationally, land values declined 19 percent from 1981 to 1985. In 1984 alone, land values declined 12 percent with \$104 billion in equity lost. The 1984 drop was the largest since the early 1930's. From April 1985 to February 1986, land values dropped yet another 12 percent. Some states experienced a sharper decline than others. For example, between 1981 and 1985, land values in Iowa declined almost 50 percent while values rose 1 percent in New York.

For farmers with little or no debt, the decline in land values has meant huge paper losses in equity. For farmers with moderate to high financial leverage, the decline in land values has meant the virtual evaporation of their equity and therefore their borrowing capacity. Cash grain and livestock producers in particular cannot generate enough earnings to service their existing debt. And with little or no equity, they cannot offer any security to lenders as basis for needed future loans.

As a result, total agricultural debt is declining and both American farmers and their lenders are experiencing adverse economic and financial conditions. For additional information on the condition of agriculture, see Financial Condition of American Agriculture (GAO/RCED-86-09 Oct. 10, 1985) and Farm Finance: Financial Condition of American Agriculture as of December 31, 1985 (GAO/RCED-86-191BR, Sept. 3, 1986).

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## Farm Credit System Financial Stress

During the 1970's, the Farm Credit System participated in the agricultural boom. From 1970 to 1986 the System's share of the lending market grew. For example, the FLB's share of outstanding farm real estate loans increased from approximately 23 percent to 43 percent of the market. Table 2.1 indicates the FLB's growing share of the real estate lending market between 1970 and 1986.

**Table 2.1: Market Shares in Real Estate Lending to Farm Sector 1970, 1980, and 1986**

Lender	Share of Outstanding Loans on January 1 (percent)		
	1970	1980	1986
Individuals & Others	38	31	26
FLB	23	36	43
Life Insurance Companies	20	15	11
All Operating Banks	12	11	11
Farmers Home Administration	8	8	10
<b>Total*</b>	<b>100</b>	<b>100</b>	<b>100</b>

\*Figures may not add to 100 due to rounding

Two factors spurred the growth in System loan volume. First, a legislative change in the Farm Credit Act of 1971 allowed System banks to increase the amount of their loans. Prior to 1971, System banks could loan a maximum of about 68 percent of the appraised value of loan collateral. The 1971 Act raised the limit on loan size to about 85 percent of the more liberal market value of the collateral. Second, System management decided to seek a larger share of the market by pricing its loans below the lending rates charged by competitors. (See sec. 3 for a discussion of how System banks price their loans.)

The deterioration in the agricultural sector during the 1980's contributed significantly to the current financial stress in the System. Many farmers had neither the cash necessary to repay their loans nor the collateral sufficient to refinance them. The System's stress has been characterized by rising levels of nonaccrual loans, declining loan volume, rising levels of acquired property, and falling retained earnings.

Since October 1985, we have issued three reports as part of an ongoing series,<sup>1</sup> assessing the System's deteriorating financial condition. In our latest report Farm Credit System: Analysis of Financial Condition (GAO/ GGD-86-150BR), we projected that the System could essentially deplete its surplus around the end of 1986, and we presented a detailed analysis of the System's future condition and prospects. That report also contains the System's and FCA's comments and our analysis. The System

<sup>1</sup>GAO's prior two reports are

—Preliminary Analysis of the Financial Condition of the Farm Credit System, (GAO/ GGD-86-13BR, Oct 4, 1985)

—Farm Credit System: GAO's Analysis of the System's Third Quarter Financial Condition, (GAO/ GGD-86-35BR, Dec 23, 1985)

incurred a loss in 1986 of \$1.9 billion and ended the year with less than \$1.5 billion of surplus. Further, there seems to be general agreement that the System's losses will continue. The following section highlights major financial trends, documented in more detail in our 1986 report

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**Rising Levels of Nonaccrual Loans**

As of December 31, 1986, the System's nonaccrual loans had increased to \$7.1 billion from \$5.3 billion at December 31, 1985, and \$1.8 billion in 1984. Nonaccrual loans are those loans on which principal and interest are delinquent for at least 90 days (unless well secured and in the process of collection) or when circumstances indicate that collection is in doubt. Accordingly, the accruing of interest on these loans is suspended. When loans are placed in nonaccrual status, the estimated losses on principal and interest are either charged off or recognized in allowance for loan losses.

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**Declining Loan Volume**

The System's loan volume is contracting rapidly. A decline in loan volume significantly affects the System's financial position because the volume of assets earning interest is reduced. At the end of 1985, net loans outstanding had declined to \$66.6 billion from \$78.5 billion at December 31, 1984. By December 31, 1986, net loans outstanding total \$54.6 billion.

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**Rising Levels of Acquired Property**

Property is acquired by the System through foreclosures or deed in lieu of foreclosure from borrowers who can no longer service their debt. The value of FLB and PCA acquired property increased from \$36 million in 1980 to over \$500 million in 1984. At December 31, 1985, the System had \$928 million of other property owned; by December 31, 1986, it had almost \$1.1 billion.

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**Falling Surplus Levels**

The System has also been experiencing a significant deterioration in its earned surplus, primarily as a result of its need to set aside increasing levels of funds in its provision for loan losses. Combined surplus at December 31, 1986, declined to under \$1.5 billion, compared to \$2.4 billion at June 30, 1986, \$3.4 billion at December 31, 1985, and \$6.2 billion at December 31, 1984.

Appendix I summarizes the volume of gross loans, nonaccrual loans, and acquired property by bank and by district as of June 30, 1986. It also

shows the percent of loan volume classified acceptable and the loan loss allowance for each bank and district.

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## Viability of the Farm Credit System Remains a Key Issue

The current financial stress being experienced by the System and the unlikelihood of an agricultural industry upturn in the near term have created uncertainty as to the System's future viability. After auditing the System's combined financial statements for the year ended December 31, 1985, an independent accounting firm reported in early 1986 in the System's Report to Investors that it believed the System was still a "going concern." That is, it judged that the System still had the ability to continue operations. This judgment was based on (1) the System's holding a substantial surplus, (2) the System's source of funding having been stabilized with the passage of the Farm Credit Amendments Act of 1985, (3) mechanisms existing for financially stronger banks to provide resources to those needing assistance, and (4) the amount of available risk funds (total capital plus allowance for loan losses) exceeding the total of high risk loans and loan-related assets.

However, unfavorable trends in the agricultural sector are expected to continue to adversely affect the System. According to the Federal Farm Credit Banks Funding Corporation's first quarter 1986 Report to Investors, a dramatic, favorable turnaround in the agricultural economy is not expected in the near future. The Funding Corporation anticipated that the levels of nonearning assets have not yet peaked.

According to the Funding Corporation, the System will report a combined net loss of \$1.9 billion as of December 31, 1986, compared to \$2.7 billion in 1985. It also announced that the System's independent accountants will issue a qualified opinion on the 1986 combined financial statements of the System. The opinion will say that the combined financial statements are fairly stated, in accordance with generally accepted accounting principles, subject to adjustments, if any, to System assets and liabilities which might be required should the System be unable to continue in its present form. In addition, the accountants will note that the System's distressed financial condition, combined with the absence of any indication of significant near-term improvement in the agricultural economy, results in uncertainty regarding the System's ability to return to profitability and to continue to obtain adequate financing without some form of external financial assistance, of which there is no assurance.

# Managing Interest Rates - A Key Challenge

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“The competitive advantage in interest rates presently enjoyed by the Farm Credit System could erode quickly if market interest rates fall sharply ”  
FCA Agricultural and Credit  
Outlook '80

Current Status of the System - Not competitive; loan volume contracting; losing market share, losing best credits; negative income The System has no strategy to retain market share as rates decline  
Funding Corporation Presentation,  
Presidents Planning Session,  
March 25, 1986

Perhaps the most crucial challenge facing the System and FCA is establishing competitive lending rates at levels which satisfy capital preservation goals. Interest rates must be set at levels low enough for the System to attract and retain creditworthy member/borrowers, but high enough to protect System capital against potential losses. Given the financial condition of the System,<sup>1</sup> its ability to meet this challenge appears doubtful.

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## How the System Sets Interest Rates

The System's banks and associations strive to set their lending rates at competitive levels sufficient to (1) cover the cost of borrowed funds, (2) cover operating expenses and loan loss provisions, and (3) meet predetermined profit objectives. Before passage of the Farm Credit Act Amendments of 1986, FCA approval of lending rates was required.

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## The Funding Corporation Role

The Funding Corporation provides System banks with loanable funds by periodically selling Systemwide securities to the investing public. All System banks are jointly and severally liable, when the bank primarily liable is unable to make payment, for ensuring that funds are available to redeem the securities at maturity.

The Funding Corporation sells both bonds and notes. Bonds are currently issued at maturities of 3 months, 6 months, and term, which mature at least 13 months after issuance. Bonds outstanding at August 29, 1986, totaled \$52.8 billion, with an average interest rate of 10.39 percent and an average maturity of 2 years, 4 months. Discount notes are short-term paper with maturities ranging from overnight to 365 days. Notes outstanding totaled \$10 billion, with an average interest

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<sup>1</sup>See GAO's report Farm Credit System. Analysis of Financial Condition (GAO/GGD-86-150BR, Sep 18, 1986)

rate of 6.34 percent and an average maturity of 55 days. Table 3.1 shows debt from 1980 through August 29, 1986.

**Table 3.1: System Debt at Year End**

Dollars in billions)

Year	Bonds			Discount Notes			Total		
	Amount	Average Interest Rate (%)	Average Maturity (Yr./Mo.)	Amount	Average Interest Rate (%)	Average Maturity (Days)	Amount	Average Interest Rate (%)	Average Maturity (Yr./Mo.)
1980	59.7	10.34	2/7	3.2	17.18	29	62.9	10.69	2/5
1981	69.9	12.66	2/7	1.4	11.78	27	71.3	12.64	2/6
1982	71.1	11.80	2/9	1.8	8.65	27	72.9	11.72	2/8
1983	68.1	11.34	2/9	4.8	9.41	23	72.9	11.21	2/7
1984	67.2	11.69	2/8	4.9	8.94	35	72.1	11.50	2/6
1985	58.3	11.02	2/7	10.5	8.15	52	68.8	10.59	2/2
1986 <sup>a</sup>	52.8	10.39	2/4	10.0	6.34	55	62.8	9.74	2/1

<sup>a</sup>As of August 29, 1986

As shown in table 3.1, total average debt cost increased by almost 2 percent in 1981, as very high bond rates and additional bond debt entered the System's debt portfolio. Since then, the average debt cost has decreased and is now below the 1980 rate. Table 3.1 also shows that the amount of outstanding discount notes more than doubled between 1984 and 1985 as System banks took advantage of low interest short-term debt to reduce their average cost of debt.

System banks notify the Funding Corporation, at predetermined dates, of the amount of funds and lengths of maturities desired. The Funding Corporation consolidates the banks' needs and, so long as the aggregate size of the request surpasses the minimum size requirement for public marketing, secures preliminary approval from the Finance Subcommittee to proceed. Then, the Funding Corporation informs some of its 144 Selling Group members (investment dealers and dealer banks) of the pending issuance, and elicits from them information pertinent to the amount, interest rate, and length of maturity, acceptable to investors.

Based on information from the banks on the amount and desired maturities, the Funding Corporation recommends to the System Finance Subcommittee interest rates and maturities to be offered to investors. These recommendations are based on Treasury interest rates, its views of the market, and economic conditions. The System Finance Subcommittee then requests the approval of FCA to issue the debt. With this approval,

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the Funding Corporation informs its Selling Group members of the amount of securities allotted to each and they in turn sell the securities to their customers. Proceeds from securities sales are wired to System banks, almost always in the amounts initially requested.

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### The District Bank Role

The amounts and interest rates paid to borrow the funds requested by each System bank become part of that bank's debt portfolio. The bank normally combine new debt with their existing debt portfolio to create new average cost of debt. The average debt cost has historically provided the base from which each bank sets its lending rates, as over 90 percent of total bank disbursements is interest on its debt. Figure 3.1 (page 42) provides an illustration of how the average processing concept works.

The timing and amount of debt participation is decided by each district bank management. The decisions are based on such factors as the amount of maturing debt (new issues generally coincide with maturing debt), funds needed to make loans, desired level of liquidity, and operating costs. Consequently, individual banks have different average debt portfolio lengths of, maturities and interest costs, which can vary up to 10 percent or more among the various districts. As shown in appendix II, September 2, 1986, the 12 Land Banks held over 70 percent of System bond debt at an average interest cost of 10.86 percent. The average bond cost of FICBS and BCS was 8.33 percent and 9.34 percent respectively.

Two Land Banks recently acted to reduce their high debt portfolio costs. The Texas Land Bank, for instance, purchased and retired more than 10 percent of its debt portfolio by entering the secondary bond market and purchasing bonds with a par value of \$282.7 million. This action immediately dropped its average debt costs by over one-half percent, but resulted in a reduction in surplus of \$35.3 million. Because of concern regarding the adequacy of System surplus, FCA has issued a directive prohibiting further debt restructuring activities.

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### The FCA Role

The FCA approves or rejects the terms of all System security issuances. During the high loan volume growth and interest rate volatility of the early 1980's, the FCA approved the terms of all System debt issuances. As noted in its Agricultural and Credit Outlook '80, FCA recognized that the System's rapid growth may result in later problems.

**Section 3  
Managing Interest Rates - A Key Challenge**

“The large sales of bonds at high interest costs has increased the System’s portfolio costs, necessitating upward adjustments in the variable rates charged borrowers. These lock in costs and slow the downward rate adjustments when market conditions ease ”

**Lending Rates Must Cover Operating Costs**

System operating costs were \$882 million in 1985, comprising about 10 percent of total System expenditures. Both FCA and FCCA believe there are opportunities to reduce operating costs throughout the System.

**System Operating Costs Have Increased**

As shown in table 3.2, System operating costs increased 42 percent, or about \$260 million, between 1981 and 1985. The largest dollar increases were for purchased services, salaries and benefits, and occupancy expense. The growth in purchased services is largely attributable to legal and consultant services and those of the System’s independent auditor. The increases in salaries and benefits and occupancy expense are discussed in greater detail below. The System has informed us that, based on its third quarter operating results, it expects 1986 operating expenses to decline by about 10 percent compared with 1985 expenses.

**Table 3.2: Farm Credit System Operating Costs: 1981 vs. 1985**

(Dollars in thousands)				
Account	1981 <sup>a</sup>	1985 <sup>b</sup>	1981-1985 Change	Change (Percent)
Directors' Expense	\$14,274	\$17,053	\$2,779	19.5
Salaries & Benefits	387,257	534,387	147,130	38.0
Purchased Services	12,528	30,539	18,011	143.8
Occupancy Expense	51,828	86,530	34,702	67.0
Comm & EDP	38,020	54,873	16,853	44.3
Travel	32,257	33,462	1,205	3.7
Ads & Member Relas	30,109	30,387	278	0.9
Supervision (FCA)	14,760	24,041	9,281	62.9
Farmbank (FCCA)	1,850	3,586	1,736	93.8
Training	9,279	7,604	(1,675)	-18.1
Other Expenses <sup>c</sup>	28,731	60,007	31,276	<sup>d</sup>
<b>Total</b>	<b>\$620,893</b>	<b>\$882,469</b>	<b>\$261,576</b>	<b>42.1</b>

<sup>a</sup>Unaudited data provided by FCA

<sup>b</sup>Audited data provided by FCCA

<sup>c</sup>According to agency officials, this account includes expenses for numerous miscellaneous cost items—such as contributions, subscriptions, and safe deposit box rentals—for which no other account is provided

<sup>d</sup>Agency officials said that no single item accounted for a significant portion of the increase. Thus, the percentage change calculation is not meaningful

Salary and Benefit Expenses Are  
the System's Principal Operating  
Costs

From 1981 through 1985, System salary and benefit expenses increase 38 percent from \$387 to \$534 million. This growth partly reflects an 11.3 percent increase in the number of bank and association personnel employed, including additional staff needed to service troubled debt. During the same period, as measured by the consumer price index, the cost of living rose 18.3 percent. The largest single year increase came in 1982, when System salary and benefit expenses increased 16.8 percent. In that year, the number of System personnel increased by 7.5 percent. The 1982 increase may also be explained by the growth in loan volume from \$66.2 billion at the end of 1980 to \$81.4 billion 2 years later. The System has informed us that in 1986 the number of bank and association personnel decreased by about 10 percent.

Employee salary and benefit expenses accounted for about 60 percent of the System's total 1985 operating expenditures. This pattern was similar for all three types of banks—FLB/FLBAS, FICB/PCAS, and BCS. For FLB/FLBAS, salary and benefit expenses for individual districts ranged from 57 percent to 66 percent, averaging 60 percent. For FICB/PCAS, such expenses ranged from 55 percent to 68 percent, averaging 63 percent. For BCS, the average was 51 percent, ranging from 45 percent to 59 percent. According to a System official, these variances may reflect differences in district compensation programs, local credit needs (including the costs of servicing troubled assets), and district labor market conditions.

Another way of viewing operating expenses is to compare them to loan activity—a measure historically used by FCA. For 1985, salary and benefit expenses per \$100 of average loan balance varied substantially. For FLB/FLBAS, the range was from 19 cents to 85 cents per \$100, averaging 40 cents. For FICB/PCAS, the range was from 31 cents to \$2.82 per \$100, averaging \$1.64. In some instances, these ranges may be attributable to decreases in loan volume and differences in individual loan size in the districts.

Senior executive officers' salaries, a component of System expenses, were highlighted in the 1985 Farm Credit Amendments Act. The amendments require these salaries to be frozen if federal money is injected in the System. From 1977 to 1985, bank presidents were paid based on a program that rewarded increases in institution size and loan volume. In 1985, a study of Chief Executive Officer compensation was performed by FCA, which approves CEO salaries. Among other things, the study compared the compensation of System CEOs to that of competitors' senior officials. The System subsequently adopted a revised CEO compensation

program that de-emphasized growth and related the salaries of System CEOs to those of the second highest paid officers in comparably sized commercial banks. As a result, the average of CEO salary ranges increased by about \$26,000.

**Table 3.3: System CEO Salaries, 1985 and 1986**

System Entity	CEO Salaries	
	1985	1986 <sup>a</sup>
Springfield	\$170,000	\$178,500
Baltimore	163,836	168,000
Columbia	189,750	189,750
Louisville	125,000	146,000
Jackson	105,930	140,000
St Louis	120,000	160,000
St Paul	180,000	195,000
Omaha	160,000	160,000
Wichita	146,000	170,000
Texas	140,000	144,000
Sacramento	180,000	150,000
Spokane	130,000	130,000
CBC	163,000	167,890
FCCA	250,000	270,000
Funding Corp	205,900	180,000
Capital Corp	—	250,000
Average	\$161,961	\$174,946

<sup>a</sup>Annualized salary of current CEO

As shown in table 3.3, in 1986, the two largest salaries were paid to the CEOs of FCCA (\$270,000) and the Capital Corporation (\$250,000). Both of these organizations were established in 1985. Between 1985 and 1986 the salaries of 10 CEOs increased, 3 stayed the same, and 2 decreased. Both of the decreases can be attributed to personnel turnover. In late 1985 and early 1986, five district bank presidents and the Funding Corporation CEO left the System. Enactment of the Farm Credit Act Amendments of 1986 does not preclude the System's directorate from raising CEO salaries.

**Occupancy Expense Has Risen**

From 1981 to 1985, System occupancy expense (including furniture and equipment) increased from \$51.8 to \$86.5 million, or 67 percent. One reason for the increase, according to FCA and System officials, was that during the late 1970's and early 1980's, a number of banks and associations engaged in new building programs in anticipation of sustained loan

Until recently the System focused its operational budgeting efforts on individual district banks and associations. Although the cost of operating the Systemwide committees, FCCA, Funding Corporation, and FCC are allotted among the banks, no Systemwide budgeting process existed. For the years 1987 through 1989, the System's Strategic and Business Plan requires each System district to adopt an "operating cost target," which is designed to "achieve a competitive system total operating cost relative to total system volume." However, costs associated with managing troubled accounts and acquired property, and those directly offset by noninterest income may be excluded from the cost targets. In addition, each district retains the authority to determine what is a competitive operating cost for its operations. District-directed operating cost strategies generally have not resulted in an efficient Systemwide operating cost structure. We believe that substantive cost control initiatives will require a detailed Systemwide action plan and a central entity with sufficient authority to insure effective implementation.

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### Rates Include Retained Earnings Objectives

System banks and associations have as part of their financial plans retained earnings objectives, which take into account System capital accumulation/preservation requirements. For example, the Baltimore District requires that its associations' retained surplus be equal to 5 percent of their outstanding loans. Generally, banks and associations would add to their lending rates to meet the target profit margin/surplus requirements.

Figure 3.1 shows a complete interest rate pricing example for an FICB/PCA rate. Appendix III provides a chart of the System's funding and lending cycle.

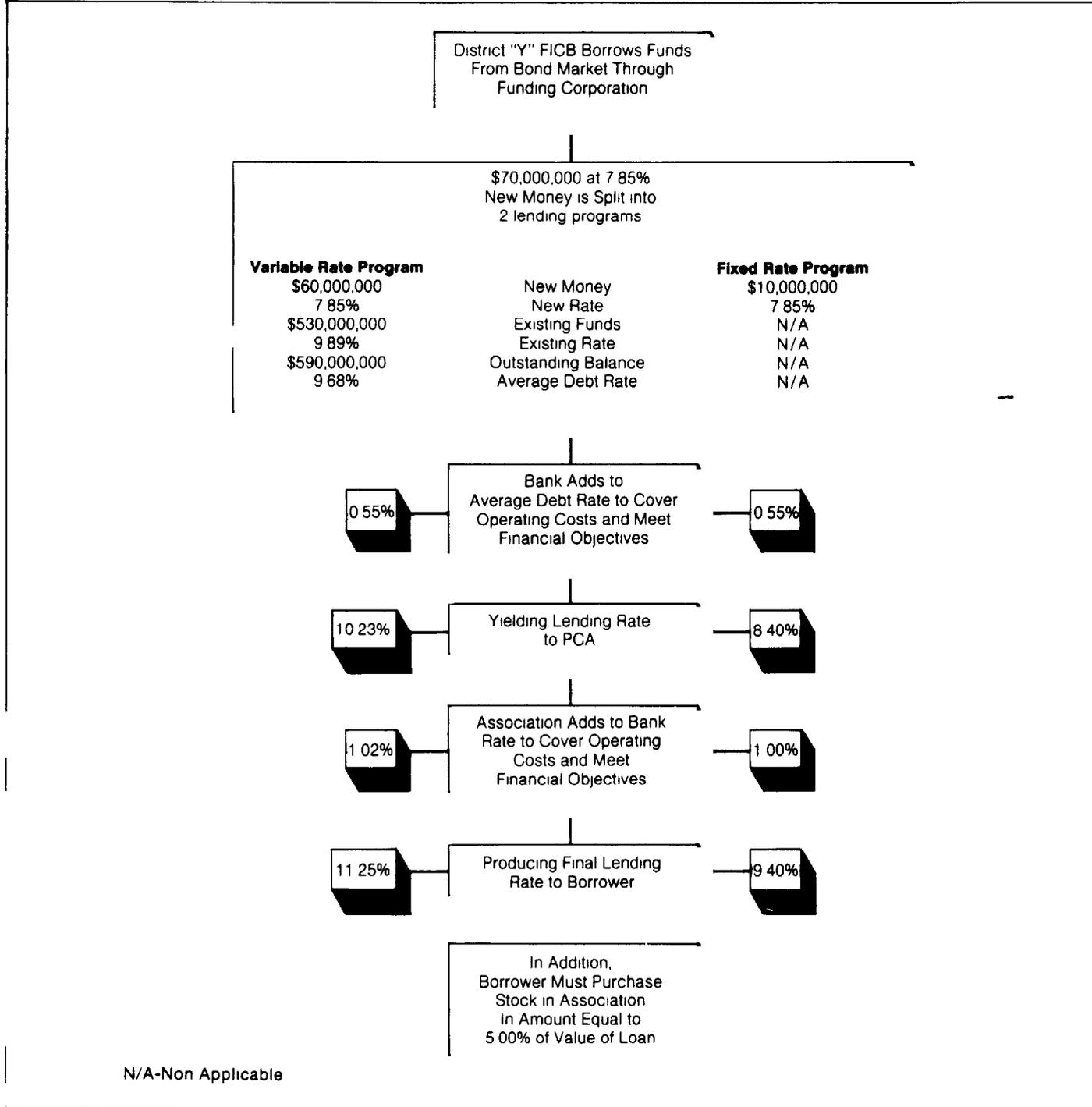
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### Are System Interest Rates Competitive?

During the 1970's and early 1980's, a period of generally rising interest rates, the System's method of pricing its loans allowed its banks to earn a profit while providing borrowers with lower interest rates than were offered by competitors. This is because average rates will generally be lower than current rates in a rising market when assets are repriced more frequently than liabilities. Competitors, such as insurance companies and commercial banks, generally set lending rates based primarily on the current cost of funds. Since the early 1980's, market interest rates have fallen sharply and the System's average rates, particularly Land Bank rates, are now higher than the current cost of funds. Thus, some of its lending rates are no longer competitive.

Section 3  
 Managing Interest Rates - A Key Challenge

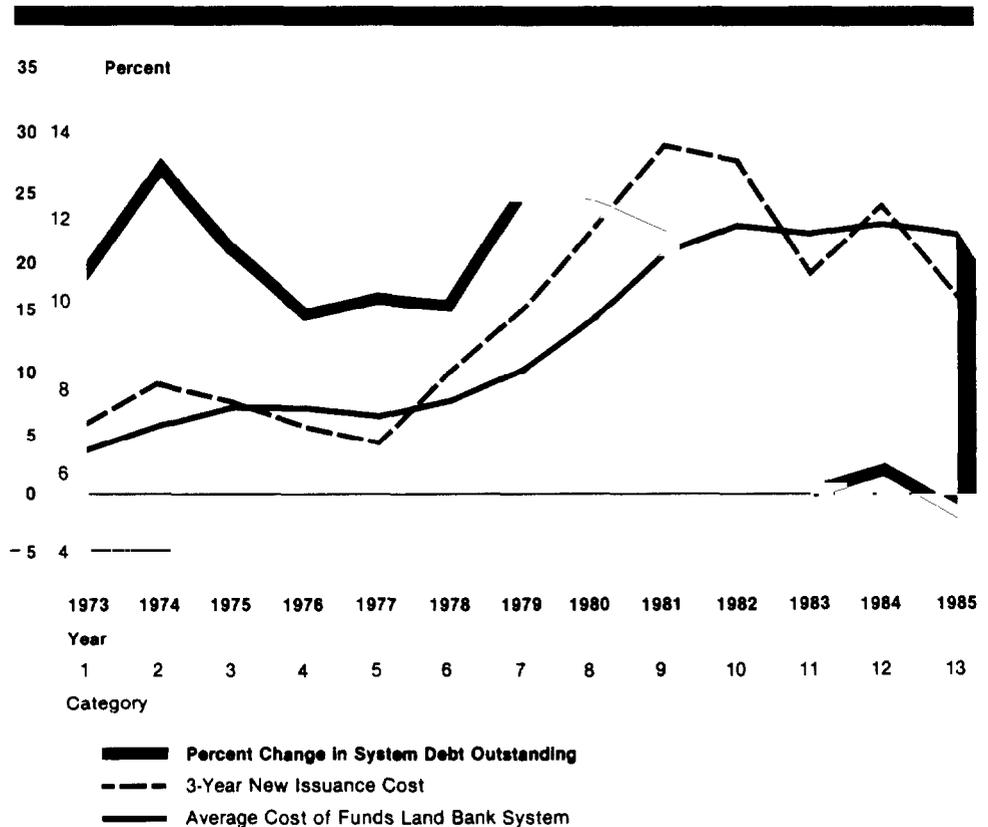
Figure 3.1: FICB/PCA Interest Rate Pricing Example



Because the System provided lower interest rates, borrowers flocked to its banks and the System had to issue considerable debt to provide the funds to satisfy the huge demand for loans. It did so during the time when market interest rates were at historical highs. Figure 3.2 compares the average debt portfolio cost of FLBs with the average cost of a new 3-year issue (approximately the average length of maturity in the FLB portfolio). The figure shows, for the period 1973 to 1985, that when FLB rates were lower than current rates, large amounts of new money entered the System. Conversely, when FLB rates were higher than current rates, less new money entered the System.

Figure 3.2 also shows that by the end of 1982, current interest rates had fallen below the Land Banks' average cost of funds. By the end of 1985, current rates were almost 2 percent lower. To date, the Land Banks have been unable to phase in enough lower cost debt so that average debt costs would more nearly approximate current rates.

**Figure 3.2: Average vs. Marginal Cost of Funds and Relationship to Outstanding System Debt**



As shown in table 3.1, the System's average cost of debt increased significantly during 1981, rising from 10.69 to 12.64 percent. This was a year characterized by high and very volatile interest rates and inverted yield curves (i.e., long-term money was at times cheaper than short-term), which followed the shift in monetary control philosophy by the Federal Reserve in 1979. For example, the System issued 6-month bonds during the year at rates which ranged from 11.5 to 17.9 percent. In July, a 3-year System term bond sold at 15.3 percent while a 10-year System term bond sold at 14.7 percent.

In the midst of this volatile market, the System issued debt of about \$9 billion, including \$13 billion in term bonds (\$10.7 billion of which were issued by FLBS), and increased its total bond debt portfolio by \$10.2 billion. The System made 20 term bond issuances during 1981, at rates ranging from 12.75 percent to 17 percent, of which 6 were for 3 years or less, 9 were for 4 to 5 years, 2 were for 8 years, and 3 were for 10 years. In each case, the term maturities were selected at the behest of district bank management and received FCA approval.

Of the \$10.2 billion of increased bond debt, \$9 billion were term bonds with maturities ranging from 2 years and 6 months to 10 years, thus locking System banks (primarily FLBS) into high cost fixed-rate long-term debt. As a specific example, in 1981 the Omaha Land Bank replaced over \$1.4 billion of 7.34 percent maturing bonds with over \$2 billion in bonds at 15.08 percent. Several years later, Omaha bank management said:

"Until the outstanding, high rate bonds mature, there is little the FLB of Omaha can do to lower the cost of bonds and, thus, little we can do to rapidly reduce the variable interest rate."

At August 29, 1986, the System's average debt cost was 9.74 percent, which is considerably higher than current rates. For example, the System issued term debt on April 9, 1986, at 7.55 percent (\$717 million of 5-year bonds) and again on July 21, 1986, at 7.35 percent (\$690 million for 34 months). Thus, given the current set of conditions, setting lending rates that merely cover the average cost of its debt places System banks (primarily FLBS) at a competitive disadvantage with other lenders who generally set their rates based on the cost of current debt.

The System's debt portfolio at September 2, 1986, contained about \$40 billion of term bonds, of which 79 percent carried coupon rates of 10 percent or more. Table 3.4 shows the coupon rates of term debt.

**Table 3.4: Percent of Term Bond Debt by Coupon Rate** (As of September 2, 1986)

Coupon Rate	Percent of Term Debt
Below 10%	21
10% to 11%	30
11% to 12%	18
12% to 13%	12
13% to 14%	8
14% to 15%	9
15% and above	2
<b>Total</b>	<b>100</b>

Many of these issues are rapidly approaching maturity. Table 3.5 shows the maturity year and average coupon rate of term debt at September 2, 1986. Although one-third of this debt will mature by the end of 1987, the remaining debt carries higher average coupon rates, exacerbating efforts to reduce the System's average cost of debt.

**Table 3.5: Maturity of System Term Bond Debt** (As of September 2, 1986)

Maturity Year	Percent of Term Debt	Average Coupon Rate
Before 12/31/87	33	11 06
1/1/88 to 12/31/88	16	11 05
1/1/89 to 12/31/89	17	11 20
1/1/90 to 12/31/90	13	11 21
1/1/91 to 4/15/07	21	11 72
<b>Totals</b>	<b>100</b>	<b>11.24</b>

Until its average debt cost declines to the market interest rate, or until the market rate rises to or above the System's average rate, the System will be hard pressed to offer competitive lending rates to all of its borrowers without incurring sizeable losses. The System can take action to prevent this type of problem from recurring.

The System needs to better manage its interest rate risk.<sup>2</sup> Interest rate risk occurs because the System does not match the repricing of its debt with the repricing of its loans. The System borrows funds to finance its loans at rates which are fixed until the issuance matures. Although it prices loans based primarily on the average cost of its debt, the System makes the vast majority of its loans at interest rates which can be

<sup>2</sup>The failure of either the System or FCA to more effectively manage interest rate risk is explored in depth in our most recent report (GAO/GGD-86-150BR, Sept. 18, 1986)

adjusted monthly (variable rate loans). The System thus has exposed itself to a significant interest rate risk because, for competitive reasons, it has not been able to pass all of its historical borrowing costs on to its borrowers.

When the System makes variable rate loans, it must ensure that the borrowings to fund those loans can be repriced at roughly the same frequency as the rates charged on the loans. When it loans long on a fixed-rate basis, it should borrow long with fixed-rate bonds and impose prepayment penalties on the loans. We would support an appropriate asset-liability management program that matched as closely as possible the frequency with which the System reprices its assets and liabilities. On page 5 of our 1986 report, footnoted previously, we recommended that the FCA direct the System banks to collectively develop and implement a plan to reduce interest rate exposure.

The System recognizes the need to better manage interest rate risk. In March 1986, the Funding Corporation proposed to System bank presidents that the System explicitly define the repricing periods for its loans and move to a market-indexed method of pricing its assets. The Funding Corporation also suggested they adopt a funding strategy embracing "Commitment to a consistent program of issuance that concentrates on short-term debt repricing. . . ."

Managing interest rate risk is one of the five objectives specified by the System in its May 1986 Strategic and Business Plan. The Funding Corporation is currently drafting the asset/liability management guidelines which System banks will use to accomplish this objective. The draft guidelines, however, still leave complete control over such liability choices as the terms and amounts of debt with the banks. While the System has traditionally maintained autonomous bank structures, greater centralized oversight and accountability may be necessary to ensure that interest rate risk is successfully managed.

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## Adequate Reserves Needed to Offset Potential Losses

To remain a financially viable lender, the System needs enough earned surplus (previously earned profits) to provide the reserves to cover the increasing loss potential in its loan portfolio. However, given the current financial condition of its borrowers in today's depressed agricultural environment, the System is not only unable to earn a profit, but also must dissipate its previously earned profits by creating a huge reserve for potential loan write-offs. As the quality of its loans deteriorates, the System must dig ever deeper into its surplus.

Considerable concern exists about the adequacy of the System's capital. Total System capital, including surplus, declined by 29.3 percent to \$8.4 billion at December 31, 1985, from \$11.8 billion at the prior year end. By December 31, 1986, it was down to \$5.6 billion. Furthermore, the System's surplus at December 31 had declined to under \$1.5 billion, compared to \$3.4 billion at December 31, 1985. When the surplus is depleted, any additional deterioration in the System's loan portfolio will require a diminution in the value of capital stock (capital impairment). The stock represents member/borrower ownership and its purchase is a legal requirement for borrowing from the System. To prevent capital impairment, the System, Congress, and FCA have initiated many actions.

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### Intrasystem Financial Assistance

System banks have entered into various contractual loss sharing/capital preservation agreements, which require that available resources be employed to deal with financial stress. Essentially, these agreements require financially secure banks and associations to assist those in difficulty by providing direct grants and purchasing high risk assets (nonaccrual loans and other property). Thus, any bank which experiences net losses severe enough to impair member stock can look to its sister institutions for assistance.

During 1985 and the first quarter of 1986, various financial assistance agreements were used to assist financially troubled System banks and associations. For example, at December 31, 1985, the FLB capital preservation agreement was activated to provide the Omaha Land Bank with \$177 million. Also, System banks provided financial assistance to the Spokane and Omaha FICBS involving direct grants totaling \$101.8 million and the purchase of approximately \$275 million of high risk assets. As part of these assistance plans, a Capital Corporation was established in June 1985 to administer the agreements and to purchase, manage, and liquidate the high risk assets. The Corporation was rechartered as a result of the Farm Credit Amendments Act of 1985.

PCAs in several other districts also experienced severe financial stress. Their FICBS generally provided them such forms of financial assistance as direct grants, forgiveness of debt, restructuring of loans, and purchases of or participation in high risk assets.

Capital preservation agreements were again activated at March 31 and June 30, 1986. The March 31 activation was to prevent capital impairment in the Omaha and Wichita FLBs. Ten FLBs accrued financial assistance totaling \$73.7 million. The accrued assistance will be paid as the

Omaha and Wichita Land Banks charge off loans for which allowance for loan losses have been established. Cash payments to the Omaha Land Bank totaling \$63 million were made by the contributing FLBs in April 1986 based on charge-offs taken during the first quarter of 1986. The June 30 activation was to prevent capital stock impairments in the amount of \$442 million in the Wichita, Omaha, Jackson (Miss.), and Louisville Land Banks.

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**Congressional Actions  
Regarding System Capital**

Under the Farm Credit Amendments Act of 1985, the Farm Credit System Capital Corporation was rechartered as a successor to the existing Capital Corporation, with authority to allocate financial resources among System entities and to acquire and service qualified nonearning assets from financially stressed System entities. Financially sound System banks will fund the Capital Corporation's operating expenses and asset acquisitions. The 1985 Amendments also authorize the U.S. Treasury to make funds available to the System, through the Capital Corporation, after the System's surplus has been substantially used—subject to recommendation by FCA, approval by the Secretary of the Treasury, and advance appropriation by Congress.

The amendments envision that the Capital Corporation will help ensure the System's continued viability by (1) mobilizing and using available System capital and reserves to assist ailing entities; (2) purchasing nonearning assets from System entities and restructuring, collecting, administering, and disposing of such assets; (3) providing technical assistance to System entities in connection with the administration of their loan portfolios, including the restructuring of loans to their borrowers; and if necessary, (4) receiving and administering any federal financial assistance that may be provided.

In October 1986, Congress passed the Farm Credit Act Amendments. Essentially, this legislation allows the System rather than its regulator, the Farm Credit Administration, to set lending rates and authorizes it to capitalize certain expenses and amortize them over 20 years. In particular, this authority allows the System to capitalize interest expense judged excessive under definitions established by the amendments and provides for losses in excess of one-half of 1 percent of loans outstanding.

On October 6, 1986, we informed the Chairman, House Committee on Agriculture, that we had serious reservations about allowing the System to disregard generally accepted accounting principles. We said this co

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result in inadequate disclosure of the System's financial position. We estimated that the accounting changes allowed by the legislation could overstate earnings by \$5 billion or more over the next 30 months.

More importantly, we wrote that this legislation could impede the speed of reforms to the management practices and operations of the Farm Credit System that were contemplated by Congress when the 1985 amendments to the Farm Credit Act were enacted into law just 9 months ago. In addition to putting the System on a solid basis of financial accounting, the amendments were designed to achieve desperately needed reforms to credit evaluation and approval procedures. In effect, the legislation may turn the clock back to the earlier era of undisciplined accounting practices and loose credit analysis and approval.

These amendments may have short-term salutary effects on the appearance of the System's financial condition but may mask realistic portrayals of its long-term viability. Reliance on legislatively sanctioned regulatory accounting in the thrift industry has taught us all too well that these short-term benefits may be far outweighed by the long-term costs of failing to deal with financial problems in a direct and forceful manner.

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### FCA Efforts to Ensure Capital Adequacy

FCA has proposed regulations prescribing capital adequacy standards and minimum capital levels for system institutions. The regulations also prescribe the responsibilities of Boards and management of each System institution for maintaining adequate capital.

In addition, FCA issued related regulations concerning the organization and operations of the Capital Corporation. A purpose of these regulations is to ensure that available System capital and reserves are committed as needed to the Capital Corporation. The 1985 Act directed FCA to establish criteria which would (1) provide for an equitable sharing of the burden among System institutions, (2) ensure that the financial positions of institutions providing funds are maintained so that reasonable and competitive credit continues to be available to System borrowers, and (3) ensure that each bank is able to borrow and repay funds in the public financial markets.

FCA's regulations pertaining to the operation and governance of the Capital Corporation drew a strong reaction from the System. The principal concerns raised included:

“(A) Excessive involvement of FCA in the management of Capital Corporation and System business operations that is inconsistent with FCA’s new posture as an arm-length regulator;

(B) Numerous efforts by FCA to inhibit normal relations between the Capital Corporation and other System institutions and the implied suggestion that the Capital Corporation will assume an adversarial posture vis-a-vis other System institutions.

The System, in its May 1986 Strategic and Business Plan, calls for the Capital Corporation to “develop and obtain system input and agreement on the Capital Corporation’s mission in accomplishing appropriate actions regarding troubled accounts and acquired property.”

The Corporation is in its infancy and its relationship with the rest of the System is still evolving. We believe it is imperative that they develop an effective working relationship to meet the challenges confronting the System.

To preserve the System’s capital until its regulations are implemented and the new Capital Corporation is functioning, FCA issued in February 1986 Capital Directive No. 1. Essentially, the directive prohibits banks and associations from taking any action outside the normal course of business that has the effect of dissipating the institution’s existing capital resources, decreasing its revenues, or otherwise diminishing its capacity to provide financial assistance to other System institutions, unless such action is specifically approved by FCA. For example, it placed restrictions on paying dividends and repurchasing any unmatured debt instruments. It also effectively froze the interest rates charged borrowers by rescinding FCA’s prior approval authority to change interest rates. However, the Farm Credit Act Amendments of 1986 remove FCA’s authority to approve interest rates, thereby superseding that portion of Capital Directive No. 1.

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**Lawsuits Hampering  
Capital Corporation  
Operations**

Numerous legal actions have been initiated by System banks and associations challenging the constitutionality of certain portions of the 1985 Amendments and contesting on several grounds the FCA’s Capital Corporation assessment regulations implementing those amendments. In one such case, the U.S. District Court for the District of Massachusetts ruled in February 1987 that FCA’s regulations and assessments made under the 1985 Amendments are invalid. The Court permanently enjoined the Capital Corporation from assessing System institutions and taking other action pursuant to such regulations.

The Funding Corporation said that in a similar action, another U.S. District Court has issued a permanent injunction precluding the Capital Corporation from assessing the three plaintiff PCAs. In a related matter, FCA has been preliminarily enjoined from unilaterally ordering the transfer of funds from the Texas District's FLB and two FLBAs and the FICB and seven PCAs, pursuant to a regulation issued prior to enactment of the 1985 Amendments.

In addition, the Funding Corporation said that a recent lawsuit by institutions which had been assessed by and had remitted payments to the Capital Corporation seeks to enjoin the Corporation from disbursing the amounts paid and to obtain a refund of such amounts. Further, several financially healthy System banks which were contributors under the capital preservation agreements have filed legal actions challenging FCA regulations which precluded the banks from reversing their 1986 third quarter capital preservation accruals. Conversely, two banks receiving assistance under the agreements have initiated litigation seeking to preclude any reversal of these third quarter capital preservation accruals. As of late February 1987, the courts had not ruled on these and other cases. Once decisions are rendered, they may be appealed by FCA, the Capital Corporation, and System banks and associations.

While the eventual outcome of these claims is uncertain, they could significantly affect the authorities and roles of the Capital Corporation and FCA as provided in the 1985 Amendments and could also result in the capital stock impairment of some financially weak banks and associations. For example, if the Capital Corporation is unable to assess financially healthy System institutions to provide assistance to weaker ones, or if there are any reversals of or refusals to pay accrued financial assistance under the capital preservation agreements, then the capital stock of some System institutions may be impaired. Regardless of the outcome of the claims, the fact remains that, pursuant to the Farm Credit Act of 1971, all 37 Farm Credit Banks are jointly and severally liable on all Systemwide bonds and discount notes.

# Maintaining an Effective Credit Management Process Under Stress

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“Farmers, and even lenders, should guard against overoptimism and possible overextension of credit.”  
FCA Agricultural and Credit Outlook '81

“Overall, loan portfolios of the Farm Credit System institutions experienced significant deterioration in credit quality in 1985, accelerating the downward trend which had begun during recent years.”  
1985 Report to Investors of the Farm Credit System

The quality of major portions of the System's loan portfolio has significantly declined in recent years, leaving managers with a higher percentage of difficult loans to administer. Moreover, several entities have a role in establishing credit policy and managing operations, and they must deal with numerous credit management problems that have contributed to the System's stress. The System is revising several aspects of its credit management, but implementing effective credit and review standards remains an important challenge made more difficult by the lack of centralized authority.

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## Overview of the Credit Process

The System's objective is to furnish American farmers, ranchers, and other eligible borrowers with sound, adequate, and constructive credit. The Farm Credit Act of 1971, as amended, sets forth the loan policies that guide System credit operations.

The 1971 Act also divided responsibility for maintaining a credit system responsive to borrower needs among the System's institutions and the FCA. The associations carry out the more direct operational credit activities, including making the initial lending decision and conducting ongoing credit administration. District banks monitor credit activities which include credit review and audit. FCA examines and regulates both the banks and associations. Table 4.1 shows the elements of credit administration at the bank and association levels.

Individuals apply for loans through the local FLBAS or PCAs. The association conducts the credit review, repayment and equity analysis, and collateral appraisal and then decides whether or not to extend a loan. Associations also service their loans. This involves on-site inspection emphasizing crops, livestock, management ability, marketing, and so on. The credit staff classifies loans according to risk level and increases their servicing activities for lower quality loans.

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**Section 4**  
**Maintaining an Effective Credit Management**  
**Process Under Stress**

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The district banks are responsible for adopting lending standards for the extension and administration of sound and constructive credit. They must design policies and procedures for controlling and reviewing association credit operations. District banks also review and audit association credit quality, credit administration, and appraisal performance to determine the overall risk in the loan portfolio, estimate losses, and document weaknesses.

FCA oversees district bank management of the scope and quality of credit services, lending risks, and the adequacy of bank and association general operations and internal controls. This includes the banks' supervision of the land bank and production credit associations. The Farm Credit Amendments Act of 1985 requires FCA to examine all system institutions at least once each year.

**Section 4**  
**Maintaining an Effective Credit Management**  
**Process Under Stress**

**Table 4.1: District Bank and Association Credit Operations**

**Association Responsibilities<sup>a</sup>**

- I Making Credit Decisions
  - A Analyze the Purpose of the Loan
    - Review Loan Request and Borrowing Reason
    - Check Applicant Eligibility
    - Analyze Business Structure
  - B Analyze the Borrower's Credit
    - Business Review
    - Management Review
    - Analysis of Financial Statements
    - Analysis of Cash Flow and Profit Projections
    - Collateral Requirements
  - C Structure the Loan
    - Risk Analysis
    - Loan Negotiation
    - Loan Decision/Recommendation
    - Loan Closing
- II Administering Credit
  - A Loan Servicing
  - B Loan Classification and Reporting
  - C Collection

**District Bank Responsibilities**

- I Managing Credit Risk
  - A Loan Pricing
  - B Lending Delegation
  - C Portfolio Concentration
  - D Loan Participations
- II Reviewing and Auditing Credit
  - A Review Credit Quality
  - B Review Credit Administration
  - C Review Appraisal Performance
  - D Conduct Internal Credit Review

<sup>a</sup>PCAs lend directly to borrowers whereas FLBAs act as agents and servicers of FLB loans. This figure shows a general description of the division of responsibilities between either type of association and district banks.

Prior to passage of the Farm Credit Act Amendments of 1986, FCA held the authority to approve the interest rates banks and associations charged their borrowers. The 1986 Act removed this authority; however, FCA will continue to review the impact of proposed lending rate

changes on the bank's financial position. This review focuses on the feasibility of the bank's assumptions and on the projected changes in net income, earned surplus, and capital adequacy.

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## Improving Credit Operations

System management recognizes the necessity of improving credit operations. Three indicators suggest the magnitude of this challenge. First, as the agricultural economy eroded over the past several years, the quality of major portions of the System's loan portfolio decreased. Second, specialists reviewing the System's credit administration found numerous deficiencies in both bank and association operations. Finally, System banks and associations are experiencing high turnover among their credit staffs. Thus, management must improve their credit operations using either a significantly reduced or relatively new staff.

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## Loan Quality Has Declined

Loan quality in both the FLBS and FICB/PCAS deteriorated in 1985 relative to 1984 while improving in the Banks for Cooperatives. June 30, 1986, figures show a continuation of this trend.

The deterioration in the land banks in 1985 was substantial. The percent of acceptable loans for the combined FLB system was 88.4 percent on December 31, 1984, but only 81.4 percent at the end of 1985 and 79.9 percent at June 1986. During 1985, nonaccrual loans as a percent of total assets tripled to nearly 7 percent, and acquired property increased from 0.6 to 1.6 percent of total assets. In the first 6 months of 1986, nonaccrual loans increased to 12.0 percent and acquired property to 2.2 percent of total assets.

The decline in quality of the loan portfolio in the FICB/PCA system was less severe during 1985 than in the FLB system. The percent of acceptable loans declined from 71 percent in 1984 to 67.6 percent in 1985 and 67.3 percent at June 1986. During 1985, when measured as a percent of FICB assets, nonaccrual loans increased from 3.3 to 5.9 percent, and acquired property rose from 0.9 to 1.4 percent. As of June 1986, nonaccrual loans increased to 7.2 percent, although acquired property decreased to 1.3 percent of FICB assets.

In the BCs, credit quality improved between December 1984 and June 1986. The percent of acceptable loans increased from 79.2 percent at the end of 1984 to 82.5 percent at the end of 1985 and 83.9 percent at June 1986. However, nonaccrual loans and acquired property increased slightly, although both totaled only about 0.75 percent of total assets at

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June 1986. Appendix I summarizes selected data on loan quality and acquired property for each bank and district as of June 30, 1986.

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**Credit Operations Criticized**

The System's external auditor reviewed bank and association credit operations in 1985 and identified several problems requiring the attention of bank management. These problems occur throughout credit operations, beginning with the associations' initial credit analyses and extending through the district banks' reviews of association operations. The auditor found, for instance, that association credit personnel need to reemphasize their analysis of the borrower's repayment capacity and to maintain current financial information on borrowers. Banks need to institute and improve continual training for both their own and their associations' credit staffs. The banks also need to expand the scope, frequency, and extent of their association credit reviews.

In some districts, credit practices such as these created an environment that promoted loan volume rather than loan quality. Table 4.2 illustrates the areas of the auditor's findings. System management concurs with these findings, has implemented some, and is attempting to implement the remaining recommendations.

In addition, FCA and the Capital Corporation critiqued bank credit practices. FCA reports their findings to each district's Board of Directors annually. The Capital Corporation conducted special credit reviews of certain districts. FCA's and the Capital Corporation's findings replicate many of those shown in table 4.2. We did not include those findings here, however, because they were specific to the particular banks studied.

**Section 4**  
**Maintaining an Effective Credit Management**  
**Process Under Stress**

**Table 4.2: Findings of Credit Reviews: District Bank and Association Credit Operations** (Findings Indicated by —)

**Association Operations**

**I Making Credit Decisions**

**A Analyzing the Purpose Of The Loan**

**B Analyze the Borrower's Credit**

—more emphasis needed on borrower's repayment capacity

—PCAs should reevaluate and improve process of collateral appraisals and assessments of recoveries. FLB appraisals should be more forward-looking in estimating reasonably foreseeable declines in value

**C Structure the Loan**

**II Administering Credit**

—current financial data on borrower repayment capacity lacking on FLB-FLBA loans

—PCAs need to improve quality and utilization of current financial data in loan files

**A Loan Servicing**

—common FLB-FLBA and FICB-PCA borrowers should be identified and common data bases maintained in order to improve overall loan servicing decisions

**B Loan Classification and Reporting**

—present loan classification system needs to be reevaluated to give more consideration to undercollateralized and past-due loans

**C Collection**

—problem loan collection, foreclosure and delinquency identification and response procedures should be improved

—adequate staffing, especially in the areas of specialized lending, loan work-out departments, credit review functions, and appraisal should be maintained

**District Bank Credit Operations**

**I Managing Credit Risk**

**A Loan Pricing**

**B Lending Delegation**

—formal continuing education and "quick response" training should be instituted or improved for loan officers, credit operations and review personnel, and association officials

**C Portfolio Concentration**

**D Loan Participations**

**II Credit Review and Audit**

**A Review Credit Quality**

—scope, frequency, and extent of credit reviews should be expanded

—procedures, scope justification, selection methodology, and reasons supporting loan classifications, etc., should be documented clearly

—present loan classification system needs to be reevaluated to give more consideration to undercollateralized and past-due loans

—improve certain technical "audit" procedures employed in the credit quality review process

—formalize comprehensive association review reporting and exit conferences at the associations and generally improve the association evaluation process

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**Section 4**  
**Maintaining an Effective Credit Management**  
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B Review Credit Administration

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C Review Appraisal Performance

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—appraisals and appraisal review documentation should be improved and standardized

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D Conduct Internal Credit Review

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Other comments

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—The Boards of the System's entities should adopt the national credit and review standards in early 1986

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—Banks should establish separate departments or functions to handle the increasing levels of acquired property

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**High Turnover Among**  
**Credit Staff**

Many highly qualified loan officers are leaving the System, and management is finding it difficult to replace them. The available data indicate voluntary turnover of nearly 20 percent of all association loan officers in 1985. The high rate of employee attrition is not limited to districts experiencing particular stress. In the Baltimore district, for example, turnover among district credit staff doubled from 8 percent in 1983 to 16 percent by 1985. Some associations lost more than half of their credit staff between 1981 and 1985.

The System's credit personnel are leaving for numerous reasons. According to the System's independent auditor and System officials, some have left because of increased job stress and the System's continued deterioration. Others left believing that they may no longer be needed once FCA begins examining all associations. Compensation may also be an issue. In the Baltimore district, for example, a 1985 salary survey revealed that the average salary paid its loan officers tended to be well below that paid by other financial employers in the area, and about 16 percent less than other Farm Credit districts.

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**New Developments in**  
**the Credit Process**

In response to its deteriorating condition and the findings from internal and external reviews, the System is attempting to make significant changes in its credit practices. First, System banks now offer differential variable- and fixed-rate credit programs and are beginning to obtain current financial information on FLBA borrowers. Second, the FCCA has started a program to improve loan officer competency and the integrity of internal credit reviews, issued national standards for credit operations, and issued guidelines for restructuring troubled debt. The 1986 Amendments removed FCA's approval authority over the lending rate offered by System banks.

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**Section 4**  
**Maintaining an Effective Credit Management**  
**Process Under Stress**

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FCCA's credit and review standards are intended to impose a greater level of consistency on all system bank lending and review practices. FCCA cites the System's adoption and planned implementation of the credit standards as a key bank and association strategy to help assess, manage, and control credit and risk. However, FCCA lacks the direct authority needed to insure compliance with its standards. Thus, although approved by all district bank presidents and boards of directors, their implementation by association credit personnel represents a major challenge.

Similarly, FCCA's guidelines on restructuring troubled debt are intended to bring a greater level of consistency to all banks' handling of troubled debt. These guidelines, which were approved by all district boards of directors, are discussed in greater detail in section 5, because of their impact on member/borrower relations.

System and FCA officials publicly disagreed over the issue of who should determine lending rates. System officials contended that FCA's refusal to approve decreases in lending rates prevented System banks from being more competitive. On the other hand, FCA maintained that its concern about lowering rates stems from its responsibility to safeguard the adequacy of System capital.

The Farm Credit Act Amendments of 1986 resolve this disagreement. They remove FCA's approval authority over the interest rates charged by System institutions. However, they also prevent System banks from charging a rate below competitive market rates for similar loans from private lenders to borrowers of equivalent creditworthiness.

# Retaining Member/Borrower and Investor Support During a Period of Financial Stress

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“Our daily decisions must be geared toward building a long-lasting, financially sound customer base which we can serve today and in the years ahead ”  
1985 Annual Report of the Farm Credit Banks  
of St. Louis

“The System’s investors will demand accurate and timely financial information on an institutional, district and systemwide basis ”  
Farm Credit System Strategic and Business  
Plan - May 1986

Retaining member/borrower and investor support for the System during this period of stress represents an important management challenge. If the System cannot maintain a creditworthy customer base, it could ultimately fail, with or without federal assistance. Likewise, if investors lose confidence in the System’s ability to manage its affairs, including relationship with the federal government, they will no longer provide funds at a reasonable price.

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## Retaining Member/Borrower Support

The System’s financial stress has introduced two sensitive issues which will affect member/borrower support—the use of debt restructuring techniques to address individual member/borrower credit problems and the disposition of property acquired through foreclosure.

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## Using Debt Restructuring Techniques to Relieve Stress

In early 1986, System officials approved guidelines and definitions for two debt restructuring techniques— forbearance and troubled debt restructuring. Forbearance is the act of a creditor who refrains from enforcing contractual obligations, rights, or claims against borrowers when a debt falls due. Troubled debt restructuring occurs when the lender grants a concession to the debtor that the lender would not otherwise consider. The difference between the two is that a lender using forbearance eventually expects to receive all that was agreed to in the original contract, while a lender restructuring a loan agrees to receive less than the original loan agreement.

The guidelines call for using either forbearance or troubled debt restructuring as preferred alternatives to foreclosure. The guidelines say that System banks, on a case-by-case basis, should use debt restructuring when the following three conditions occur:

- The borrower had acted in good faith to manage his business affairs and had been cooperative with the banks or association.

- The borrower could present a plan with reasonable assumptions showing a high probability of returning to financial viability as a result of restructuring.
- The restructuring alternative chosen will minimize any loss to the bank or association and other borrower/stockholders.

The objectives of the guidelines are to generate the greatest return of principal and interest to the System while protecting the interest of other stockholders and to standardize key definitions which differentiate between normal forbearance and troubled debt restructuring to encourage consistency in application.

Addressing member/borrower problems in its 1986 Agricultural Outlook, FCA said that no affordable federal financial assistance program will be able to prevent many borrowers from being forced to liquidate some assets or go completely out of business. Within this environment, the report noted one member/borrower implication that may be a “sleeper” for the System—forbearance. Examples of forbearance include rescheduling of principal and interest payments, change of installment dates, and renewal of unpaid principal and interest.

Noting that forbearance will be a “delicate issue in the period ahead,” the report said that the desire to keep a person in business must be balanced against the risks that the borrower will lose most of his or her equity if economic conditions continue to deteriorate. The report also pointed out that there is a risk that System banks will sustain additional loan losses from forbearance, which can threaten the financial viability of the institution if a large number of accounts are involved.

The report concluded by warning that the System’s actions may not meet borrower expectations. It said that borrowers perceive that the System will have access to an unlimited line of low- or no-cost credit. As a result, borrowers will expect the System to respond to their needs for forbearance. However, forbearance will not be easy to implement because the growth in nonperforming assets and the sharp drop in net earnings will constrain the System’s ability to help troubled borrowers, particularly in the immediate future.

As an alternative to applying forbearance, System banks could restructure the borrower’s troubled debt. Examples of debt restructuring include modifying the terms of a debt by reducing the stated interest rate for a period of years, extending the maturity date at an interest

rate lower than the current market rate, reducing the principal amount of the debt, and reducing the accrued interest.

Restructuring troubled debt will present System officials with both managerial and financial challenges. The guidelines on restructuring troubled debt provide that each district should establish one main focus point or specialized unit to administer debt restructuring. Banks may need to hire additional staff for this unit, causing operating costs to increase. Each district should also develop a system to follow up and supervise completed debt restructuring actions to ascertain the effectiveness of its program. In addition, restructuring troubled debt will increase each bank's financial stress because a loan that has been restructured returns less than originally agreed upon. Consequently, because many banks are already experiencing severe financial stress, their ability to restructure may be limited.

## Managing Acquired Property

The System now owns substantial acquired property which represent the remaining assets after all efforts to administer forbearance and troubled debt restructuring have been made. Property owned by the System has risen dramatically from \$505 million as of December 31, 1984, to over \$1.1 billion as of December 31, 1986. As noted in the Farm Credit Banks of St. Louis 1985 Annual Report, acquired properties pose a "special concern":

"Holding property is a heavy financial burden, and selling the property back onto an already depressed market must be carefully managed or it could drive farm land values even lower "

According to System guidelines, implementing an effective acquired property program requires: (1) establishing clear lines of program authority and responsibilities, (2) developing and maintaining an information system on all acquired property to allow management to control assets and monitor program performance, (3) developing and maintaining information on potential customers, and (4) training employees on how to market acquired property aggressively while projecting a positive System image.

In a March 1986 letter, the System's external auditor assessed the System's acquired property management and recommended that banks should (1) establish a separate operating department for handling acquired property, (2) provide employees with additional training, and

(3) consider establishing comprehensive automated information systems to account for acquired property.

System banks are making progress in addressing these recommendations. A May 1986 status report by the President of the Funding Corporation to the System Finance Subcommittee noted that the effort to establish a standardized automated accounting system for acquired property has been hampered by a lack of standard automated equipment and systems among the districts. However, the System has subsequently informed us that its districts have established separate departments to handle acquired property.

The Farm Credit System's 1986 Strategic and Business Plan also contains objectives concerning member/borrower issues including working with troubled accounts and attracting and retaining quality customers. Each objective is supported by a set of Systemwide and individual bank and association strategies scheduled to be completed in calendar year 1986, but their effective implementation remains a key issue. The objectives include:

- Establishing a Systemwide data system to allow FCCA to monitor compliance with loan restructuring and acquired property guidelines.
- Initiating programs to identify and personally contact potential high quality customers.
- Establishing programs to "mend fences" with borrowers and bring back customers who have left the system.
- Encouraging each bank to review and evaluate existing human resources programs, including training programs.

Because the System lacks centralized and accountable management, it may not be able to ensure that its entities implement the Systemwide objectives.

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## Maintaining Investor Support

Maintaining the System's ability to raise needed funds at reasonable prices in the investment market remains an essential System need. Investor confidence historically has been influenced by government actions and access to timely and accurate information on the System's financial condition. These factors will continue to influence future investor actions.

**The Farm Credit System  
 Obtains Funds in the  
 “Agency Market”**

The Farm Credit System is part of a group of privately owned federal instrumentalities called government-sponsored enterprises (GSE). GSEs were established and accorded favored regulatory treatment to increase access to the capital market for specific economic sectors—including agriculture—thought to be inadequately served by fully private lenders. Table 5.1 illustrates the nature of this favored regulatory treatment.

**Table 5.1: Benefits Enjoyed by GSEs**

Type of Benefit	Farm Credit System	Federal Home Loan Bank	Federal Home Loan Mrtg. Corp	Federal National Mrtg. Assn	Student Loan Market Assn
Line of Credit at Treasury	Yes	Yes	Yes <sup>a</sup>	Yes	
Exemption of corporate earnings from Federal income	Yes <sup>b</sup>	Yes	No	No	
Exemption of interest income of investors from State and local income taxes	Yes	Yes	No	No	
Eligibility for Federal Reserve open market purchases	Yes	Yes	Yes	Yes	
Equal Standing with Treasury debt as investments for most banks	Yes	Yes	Yes	Yes	
Exemption from SEC registration and various State banking laws	Yes	Yes	Yes	Yes	
Eligibility as collateral for public deposits	Yes	Yes	Yes	Yes	

<sup>a</sup>Indirect line of credit through the FHLBs

<sup>b</sup>FLBs, FICBs, and FLBAs

Although these “special arrangements” do not include an explicit guarantee by the federal government, they are still significant enough to make the investment instruments of GSEs particularly attractive. One such indication is the low interest rates GSEs pay for their debt when compared to other private enterprises. For example, for comparable maturities during calendar year 1985, A-Rated corporate bonds sold for between 2 and 3 percent above Treasury rates, while most GSE bonds consistently sold for less than one-half percent above Treasury rates.

The System actively participates in the agency market. Its 1986 Financing Calendar calls for 20 bond offerings—12 6-month offerings and 8 term offerings (maturity lengths are based on the banks’ needs). In addition, discount notes are offered daily. System financings have risen from \$51.8 billion in 1978 to \$89.6 billion in 1985.

System securities are structured to attract a wide range of investors—commercial banks, insurance companies, state and local governments, fiduciary accounts (pension funds, etc.), and thrift institutions. These

institutions have significant liquidity management and fiduciary challenges (unexpected deposit flows or loan demands, unpredictable cash outflows, etc.) that the System's securities mix—discount notes and short maturity bonds—can help manage. The System estimates that typically 46 percent of its securities are purchased by commercial banks, 22 percent by state and local governments, 10 percent by thrift institutions, 2 percent by pension funds, and the rest by other investors.

System securities are marketed by the Funding Corporation through its Selling Group, which is made up of 144 dealers (86 bank dealers and 58 nonbank dealers). Selling Group members provide pricing estimates for each issuance, initially distribute allotments of each System issuance to investors, and provide a "viable secondary market" for each series of System bonds. The Funding Corporation pays each Selling Group member a concession, normally \$0.30 per \$1,000 for 3-month securities, \$0.50 per \$1,000 for 6-month securities, \$2.00 per \$1,000 for 5-year securities, increasing to \$3.50 per \$1,000 for 15-year securities. The concession on discount notes amounts to 5 basis points (one basis point equals one one-hundredth of a percent).

Funding Corporation operations are reviewed annually by FCA and were reviewed in 1985 by the System's independent auditor. In its 1985 review, FCA concluded that the Funding Corporation is "satisfactorily managed from both an operational and a functional standpoint," and that the management of the Selling Group "continue[s] to be handled effectively." The independent auditor also found no significant problems with the Funding Corporation's financing operations.

To obtain additional insights into Funding Corporation activities, we compared its 1985 operations to those of the Federal Home Loan Banks (FHLB), the only GSE whose securities have attributes identical to System securities. Our comparison is shown in table 5.2.

Table 5.2: Funding Operation Comparison - Farm Credit System vs. FHLBs

1985 operations	System	FHLBs
Gross debt		
—Bonds	\$25.4 billion	\$27.1 billion
—Discount Notes	64.2 billion	26.3 billion
Average maturity of debt issued	1 yr 3 mos	2 yrs 11 mos
Average interest rate of debt issued	8.90	9.49
Funding operation expenses	\$4.1 million	\$4.9 million
Concessions paid to dealers	\$23.6 million	\$48.1 million

As shown above, the FHLBs paid considerably more in concessions than the Funding Corporation. One reason for this may be the longer maturities of FHLB issuances. As noted earlier, concession rates are higher for longer maturities.

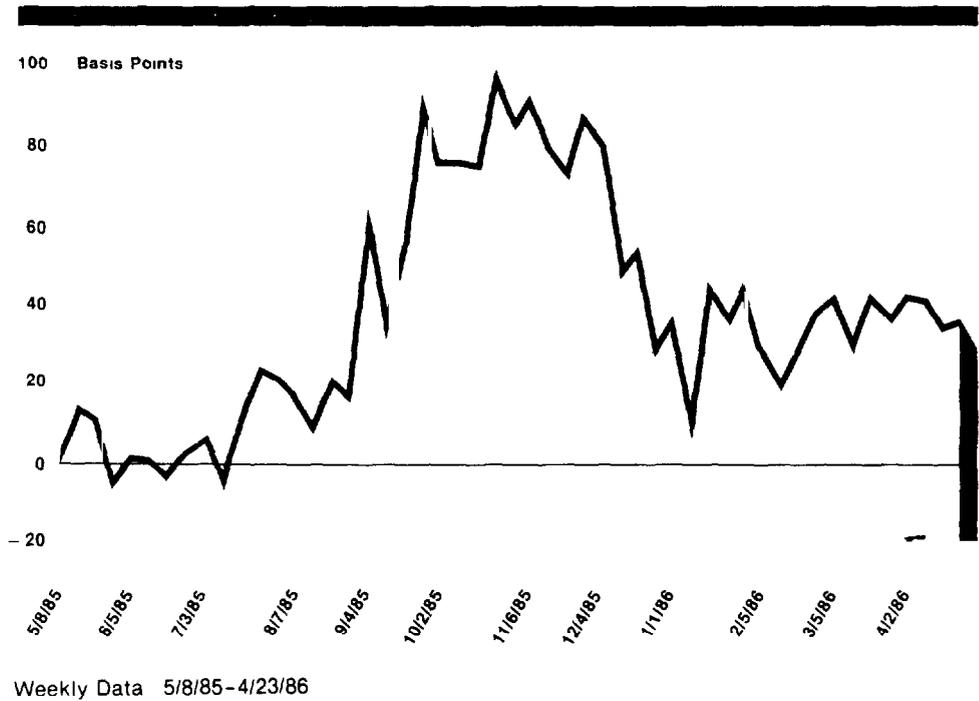
### System Securities' Prices Fluctuate

As a result of the depressed agricultural economy and the System's financial problems, the issuance of its securities began to be adversely affected by late summer 1985. This was clearly demonstrated by the differential in pricing spreads (the difference between the price of a System security and the price of a comparable Treasury security) between the first and second half of the year. Through the July 22, 1985, financing, the average pricing spread on total bond financing activity was 5 basis points, while for the balance of the year the average was 55. During the fall of 1985, the pricing spread rose to about 100 basis points over Treasury issues for some System issuances.

One reason for the 1985 amendments was to restore investor confidence in the System's debt and thus to lower the risk premium being required by the market. When investors became increasingly confident of legislative action in mid-December, these spreads narrowed to about 50 basis points. To illustrate these fluctuations, figure 5.1 shows the weekly average spread between 6-month System bonds and comparable Treasury bills in the secondary market for the 51-week period May 8, 1985 through April 23, 1986. As shown in figure 5.1, the spread at April 23, 1986, had dropped to the 30 to 40 basis point range.

The five major System securities dealers and the bond rating service that we talked with all believed that the 1985 amendments were a needed reaffirmation of the government's commitment to the System. However, four of these dealers and the rating service also believed that the level of future prices paid by the System will reflect the market's perception of how well the amendments are being implemented. In particular, the System's relationship to the federal government will continue to be monitored as the market assesses the willingness and ability of the government to extend support.

Figure 5.1: Spread Between 6-Month System Bonds & Treasury Bills in Secondary Trading



Investment Community Will Continue to Monitor System Financial Information

Historically, the investment community’s perception of the System has been shaped in part by the quality and timeliness of the System’s financial statements and the community’s perception of the strength of federal support. Recognizing this, the System in 1985 engaged a certified public accounting firm to audit its financial statements, thereby increasing its efforts to disclose System financial information to the public.<sup>1</sup>

The System’s auditors recognized the need to provide investors accurate and timely information. In a March 1986 report on key findings resulting from their 1985 year-end examination, the auditors provided a list of “matters requiring Systemwide action.” The list included

- developing and implementing an automated Systemwide financial system including standardized data bases and general ledger accounting software,

<sup>1</sup>We previously had recommended the use of external auditors in How the Farm Credit Administration Can Improve its Use of Auditing (GAO-81-22, Jan 28, 1981)

- determining an appropriate quarterly allowance for loan losses based on generally accepted accounting principles including recognizing charge-offs as soon as actual losses become known,
- providing timely and reliable quarterly financial data to respond to increased public and regulatory pressure for information, and
- preparing realistic forecasts of the System's financial prospects to be used in evaluations by FCA and other government agencies.

The System has made progress toward resolving these issues but more remains to be done. In a May 1986 memorandum, the President of the Funding Corporation provided a status report to the System Finance Committee on each of the auditor's "matters requiring Systemwide action." The memo stated that the implementation of the new financial reporting system has experienced delays due to staff shortages. Regarding the allowances for loan losses and quarterly financial information, he wrote:

"The Banks are slow in recognizing charge-offs and appear to be reluctant to make adequate restoration to the allowance for loan losses after taking charge-offs. The educational process on this subject must be continued through the Accounting Standards Committee and Price Waterhouse. In some cases, it will be necessary for the System Finance Subcommittee to require corrective action on the part of some individual banks."

Addressing the status of financial forecasting in the System, he noted that the most recent System financial forecast "lacks credibility." He believes additional management direction will be required if the forecasts are to improve.

Effectively implementing the initiatives supporting full and accurate disclosure of financial information to member/borrowers and investor remains an important management issue. More centralized and accountable management with the authority to ensure implementation of the Systemwide initiatives by System entities may be necessary. Few things would be more devastating to the potential recovery of the System, with or without federal aid, than inaccurate or untimely financial data being released to customers and investors.

